

# **Principles and Practices Of Financial Management**

## **Wesleyan Assurance Society (Medical Sickness Society Fund)**

**Effective from 1 March 2021**

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## Introduction

Wesleyan Assurance Society, founded in 1841, is a mutual Society incorporated by Private Act of Parliament. Certain categories of policyholders are members and have the right to vote at general meetings. Wesleyan and its subsidiary companies undertake long term insurance business, investment advice, insurance broking, unit trust management, mortgage broking and retail banking. In 1997 Wesleyan merged with *Medical Sickness Society*, another mutual Society, which was itself founded in 1884. A closed fund called the *MSS Fund* was established containing the *Medical Sickness Society With Profits* business. Almost all the Medical Sickness non-profit business was transferred to the *Wesleyan Open Fund*.

Since 30 April 2004, all insurance companies issuing “With Profits” policies have been required to establish and maintain their “Principles and Practices of Financial Management” (PPFM).

This document, which is available on our website and can also be sent to you on request, is intended to provide protection for current and future With Profits policyholders by explaining how we will manage our With Profits business.

We will have to provide a report to policyholders each year certifying that we have operated the business in line with the PPFM, and let them know if we make changes to it.

Within each section of this document, we firstly set out the “Principles” and then the “Practices”.

Principles are high level, enduring statements of the standards we adopt. They are not intended to change very often and when they do we are required to tell With Profits policyholders at least three months in advance.

Practices describe our current approach to managing the With Profits funds and these may change more often. When they do, we have to tell With Profits policyholders within a reasonable time period thereafter.

We have produced two different PPFM documents. This one relates to policies in the *MSS Fund*. There is a separate PPFM document for policies in the *Open Fund*.

We have included a glossary to explain the most common technical words and phrases. Where we use a word or phrase, which is included in the glossary, we have printed it in italics.

If you have any queries about this document, please contact our Customer Relationship Centre on 0800 092 1990 or, if you are a My Wesleyan customer, log into your account at [www.mywesleyan.co.uk/login](http://www.mywesleyan.co.uk/login) and correspond with us securely via ‘Messages’.

Note: This introduction and the glossary are provided for explanatory purposes only and do not form part of the Principles and Practices of Financial Management itself.

## 1. The amount payable under a With Profits policy (MSS)

### 1.1 Principles

#### 1.1.1 Methods of determining claim values

The aim of the method of determining bonus rates is to distribute fairly all of the assets of the *MSS Fund* to the remaining policyholders in the fund as the policies become claims. This is assessed using *asset shares*. When setting bonus rates, *asset shares* are calculated for a range of sample policies. They are used as a guide to determining the amount payable, which for an individual policy may be more or less than that policy's *asset share*. *Asset shares* are not calculated for some minor policy classes.

Each year *asset shares* are adjusted so that the aggregate of the *asset shares* is equal to the *Credit Balance* of the fund, after allowance for future profits and losses to which the fund is exposed, less a margin for *smoothing*.

The current methods used to calculate and adjust *asset shares* are described in the Practices. Any significant changes to these methods will be approved by *the Board*, having had advice from the *Actuary* and considered the opinion of the *Monitoring Committee*. Less significant changes will be approved by the *Actuary*.

Past adjustments to *asset shares* might be changed as part of the process of equating the aggregate *asset shares* to the *Credit Balance* each year. Any changes to past adjustments will be considered by the *Monitoring Committee* and approved by the *Actuary*. Other historical assumptions or parameters will only be changed when a subsequent investigation reveals an inaccuracy or when there is a change in method. Any significant changes will be approved by *the Board* having had advice from the *Actuary*. Less significant changes will be approved by the *Actuary*.

#### 1.1.2 Bonus policy

In accordance with the *Merger Scheme* the following items are taken into account when formulating the bonus policy for the *MSS Fund*:

- achieving equity between different types of policy in the fund;
- the financial position of the fund; and
- the previous bonus distribution policy of *Medical Sickness Society*.

Bonuses must be declared such that the whole of the surplus of the *MSS Fund* is progressively and equitably distributed to the policies in the fund.

The *Merger Scheme* provides that once the number of policies in the *MSS Fund* falls below 5000, the *Actuary* may recommend that the *MSS Fund* merges with the *Open Fund*. For such a recommendation to proceed it must be accepted by *the Board*, after consultation with the *Monitoring Committee*. Regulatory approval would also be required. After such a merger, the principles to be taken into account in relation to bonus policy include:

- achieving equity between different types of policy;
- achieving equity between former *MSS Fund* policies and other Wesleyan With Profits policies; and
- that former *MSS Fund* policyholders have no expectation of receiving any distribution of the estate within the *Open Fund*, but that the existence of this estate will be used to help *smooth* bonuses and claim values.

### 1.1.3 Annual bonus

The aim in setting *annual bonuses* is to increase guaranteed benefits gradually whilst leaving a suitable margin between our best estimate of future investment returns and the return that needs to be earned to be able to pay out the guaranteed benefits at maturity. Any changes in *annual bonus* rates will be gradual (unless this puts the solvency of the fund at risk) and will broadly reflect changes in the general level of past and expected future investment returns. It is possible that a period of poor investment returns could lead to zero *annual bonuses* for some or all policies in the fund.

The fund is closed to new business and so no new bonus series will be introduced.

### 1.1.4 Final bonus

The aim in setting *final bonus* rates is that policyholders should receive their policies' fair share of the fund. This is assessed using *asset shares* as described in the Practices. We also apply *smoothing* in line with the *smoothing* policy described below. If the benefits guaranteed to be paid by a policy already reflect at least that policy's fair share of the fund then we may not add a *final bonus*.

### 1.1.5 Smoothing policy

Maturity and death claims are subject to the same level of *smoothing*. Less *smoothing* is applied to surrender and transfer claims.

When adjusting *asset shares* a margin is held back between the value of the fund's assets and the aggregate of the *asset shares*. This margin allows us to operate our *smoothing* policy.

No limit has been set on the *smoothing* cost that is considered to be acceptable in the short term. A limit would be set if the financial strength of the fund was considered to be sufficiently low that such action should be taken.

Surrender value bases are reviewed regularly. Resulting changes to the basis will reflect any changes in the experience of the policies under consideration.

## 1.2 Practices

### 1.2.1 Methods of determining claim values

#### Life assurance policies

The amount payable on death or maturity is the sum assured plus *annual bonuses* plus any *final bonuses*. The amount payable on surrender is a proportion of this and is determined with reference to a formula.

#### Pension policies with benefits expressed as a cash fund on retirement

The cash fund available at retirement is the capital amount plus *annual bonuses* and any *final bonuses*. For early and late retirements the benefits are recalculated based on the premium rates at the outset of the policy, where available.

Depending on the type of policy it may be possible to take part of the cash fund as a tax-free lump sum. The remainder may be used either to purchase an *annuity* or taken as a taxable lump sum. The *annuity* will be subject to a minimum of the *annuity* calculated using the *Guaranteed Annuity Rates (GARs)* specified in the policy literature. The basis underlying the *GARs* is applied at retirement irrespective of the actual retirement age, up to a maximum retirement age of 75.

The amount payable on transfer is a proportion of this and is determined with reference to a formula. The amount payable on death is either the return of the premiums paid to date or the return of the fund purchased to date, depending on the choice made by the policyholder at the outset. The return of fund is currently equal to the transfer value as described in section 1.2.4.

#### Series 1 & 2 deferred annuity policies

Benefits for these policies are expressed in terms of an *annuity*. The amount payable is the *annuity* plus *annual bonuses* together with any final and vesting bonuses. The amount payable on death is the return of the fund purchased to date and is currently equal to the transfer value.

#### With Profits annuities in payment

The amount payable may be increased each year following any declaration of an *annual bonus*.

#### With Profits income protection policies

The sickness benefit is the sum assured and no bonuses are payable on this amount. The amount payable on maturity or death is the sum of the *annual bonuses* declared plus any *final bonuses*.

The current aim of the method of determining bonus rates is that With Profits policyholders should receive their fair share of the fund. Over the full term of the fund, the total assets will be paid out. For most policies this is assessed using *asset shares*. Claims on maturity or retirement are targeted to equal 100% of the adjusted *asset share* over the long term. In any one year, the amounts paid out may be more or less than adjusted *asset shares*.

For *annuities* in payment and income protection policies the methods of determining bonus rates are explained in sections 1.2.2 and 1.2.4 below.

#### 1.2.1.1 Asset shares

*Asset shares* are determined on a yearly basis. The *asset share* is built up month by month as follows:

	<i>Asset share</i> at start of month
Plus	premiums received
Plus	investment return
Minus	claims paid
Minus	charges for expenses
Plus or minus	past adjustments

Items are based on the actual experience of *Medical Sickness Society* before 1 July 1997 and the *MSS Fund* after 1 July 1997, apart from the adjustment process set out below. Where appropriate the investment return allows for tax including an estimate of the value of any future capital gains tax. Tax relief on expenses is also allowed for.

The minor classes for which *asset shares* are not currently calculated are whole life policies, single premium pension policies, income protection policies and *annuities* in payment.

For whole life policies, death claim values use the same bonus rates as an endowment policy of the same duration. Single premium pension policies receive the same bonus rates as regular premium pension policies.

#### Investment return

The investment return allocated to *asset shares* is the investment return earned on the relevant assets as described in section 2 below for the period since 1 July 1997 and the Medical Sickness long term fund for investment returns earned before 1 July 1997. This return is calculated gross of tax for pensions business and net of tax for other business. We do not currently apply different investment returns to different types of policy. All policies have the same asset mix in their asset shares.

#### Charges for expenses

The charges for expenses are equivalent to the charges made to the *MSS Fund*. These are described in more detail in section 4.

#### Asset share adjustments

To ensure that all the assets of the fund are distributed to policyholders the *asset shares* are adjusted as described below.

At the establishment of the fund on 1 July 1997 the fund's assets were compared with the aggregate of the *asset shares* of in-force policies. The assets were adjusted to allow for deferred taxation, the small amount of non-profit business remaining in the fund and other expected future costs or benefits to the fund. A margin equal to 10% of the adjusted asset value was also held back to allow the *smoothing* policy to be operated and to guard against adverse future experience. The *asset shares* were then enhanced so that the aggregate *asset shares* equalled the net assets of the fund. The enhancements consisted of a fixed addition to the investment return for each of the

twenty years before the merger plus a percentage increase to the *asset share* at the date of the merger.

This comparison is repeated at the end of each calendar year. The net assets of the fund are compared with the aggregate of the *asset shares*, and any difference allowed for by adjusting the margin, the *asset shares*, or both. Adjustments to *asset shares* are normally by a fixed percentage but past adjustments to *asset shares* may be altered as part of this process.

Past and future *guarantee costs* (other than *Guaranteed Annuity Rate* costs) arising on each type of life or pensions contract are, as far as possible, only charged to the *asset shares* of that type of contract, with the initial impact smoothed over a three year period.

### Asset share procedures

The aggregate *asset shares* are calculated in the same way as the sample *asset shares* described above. *Asset shares* are calculated individually for most policies. Pension policies, however, have a history of flexible payments for which there is insufficient data available to calculate precise *asset shares*. Instead, the ratio of *asset share* to guaranteed benefits is calculated for sample policies of various ages, terms and duration in force and the resulting factors are applied to the guaranteed benefits for each policy to estimate the *asset share* for that policy.

The aggregate *asset shares* for With Profits *annuities* in payment, series 1 deferred *annuities* and With Profits income protection policies are estimated using approximate methods based on the guaranteed benefits.

The basic underlying method is described in papers presented to the *Monitoring Committee* and *the Board*. More detailed descriptions of the methods used are maintained within the Actuarial Department. Each year a document is created specifying the parameters relating to that year. These parameters are approved by the *Actuary*. No subsequent approval is needed where these figures are used in later year's calculations.

### 1.2.2 Annual bonus

*Annual bonus* rates are set once a year. We currently aim to set *annual bonus* rates so as to leave a suitable margin between our long term best estimate of future investment returns and the rate that needs to be earned in order to be able to pay out the guaranteed sum assured and *annual bonuses* at maturity. When the margin being left is too large or too small, the *annual bonus* rates are moved smoothly towards the target rate. To assess the margin, we compare

- The amount of final bonus we currently expect to pay at maturity based on the long term best estimate of future investment returns, and
- The amount of final bonus we expect the margin described above to provide at maturity.

This comparison is performed for a number of specimen years of entry and policy terms for each product type. We would consider results from all of these specimen comparisons before deciding to change annual bonus rates.



For policies where the guaranteed benefits are greater than *asset share* the effect of the guarantees (excluding *Guaranteed Annuity Rates*) on the solvency of the fund are taken into account when setting *annual bonuses*. *Annual bonus* rates may fall to zero, for example where the current guaranteed benefits exceed the expected *asset share* at maturity.

After considering these factors, the *Actuary* makes a recommendation to *the Board* as to the appropriate *annual bonus* rate for each policy class.

There is no specific limit on the amount by which *annual bonus* rates may change. Interim bonus is added to the amount payable on claim to cover the period between the last bonus declaration and the claim. Our current practice is to set interim bonus rates equal to the rate of *annual bonus* set at the most recent declaration.

*Annual bonus* rates for *annuities* in payment have regard to the *annual bonus* rates for series 1 deferred *annuity* policies and are based on a general assessment of the financial position of the fund and the bonus loadings included in the *annuity* rates in the premium basis from time to time.

*Annual bonus* rates for income protection policies are set equal to rates covered by the reinsurance treaty in place. They will only be varied if the solvency of the fund is considered to be in danger.

### 1.2.3 Vesting bonus

Vesting bonus may be added to the claim amount on retirement for series 1 and 2 deferred *annuity* policies. These policies have benefits expressed in terms of *annuities*. The vesting bonus is designed to compensate for differences between the patterns of future mortality and the mortality in retirement assumed in the original premium basis, or interest rate differences. This ensures that policyholders who retire at different ages to those assumed for the sample *asset shares* are treated fairly. Vesting bonus rates are reviewed whenever the mortality assumptions in *the Society's annuity* basis are changed, or whenever there are significant changes in the shape of interest rate assumptions. If the guaranteed benefits for these policies are greater than *asset share* and no *final bonus* is payable, no vesting bonus will be declared.

### 1.2.4 Final bonus

#### Maturity & death claims

When policies maturing during the following year were written on different premium rates, different *final bonus* rates may apply to policies written before and after the change. Normally the *final bonus* rates would be set so that the payouts are similar.

*Final bonus* rates for other policy terms are derived by interpolating between the bonus rates for policies with terms that are multiples of five years and then refining the rates to produce a *smooth* progression of *final bonus* rates as term increases.

The proposed maturity proceeds are also compared with the premiums paid and when necessary the *final bonus* rates are increased to ensure that we treat customers fairly. This is assessed by considering whether the yield earned by the policyholder on the premiums paid is reasonable.

The *final bonus* rates for death claims are the same as those set for maturing endowment policies with the same duration. For whole life policies this represents an approximation as no detailed *asset share* calculations are performed.

*Final bonus* rates for With Profits policies are set at least once a year. When intermediate changes are made the current procedure for calculating *final bonus* rates is less detailed. Changes in maturity payouts are determined by considering the investment return achieved in the period since the last annual investigation and the investment return expected to be achieved in the period until the next annual investigation, with the aim of producing a reasonable transition from current maturity values to those likely to be payable after the next declaration. *Final bonus* rates are then set to achieve these changes in payout, subject to a minimum of the guaranteed benefits.

We may uplift the final bonus on claim to allow for a policy's share of the current margin that is being held back in the Fund to protect against adverse experience. . The value of this uplift depends on the financial health of the *MSS Fund*.

#### With Profits income protection policies

For With Profits income protection policies, *final bonus* rates would be declared if the average investment returns over the period since the merger were significantly in excess of 7.65%p.a. gross, and would reflect the excess of those returns over that rate. The rate was established at the time of the merger based upon previous practice and the investment conditions at the time. No *final bonus* had been declared for some years prior to the merger because of a deterioration in sickness claims experience.

#### Surrender & transfer values

Surrender values are calculated with reference to a formula. For most policies the benefits that the policyholder would be entitled to if they retained their policy until maturity without paying any more premiums are calculated and then discounted back to the present time. The *final bonus* rates for maturity and death claims for the elapsed duration of the policy are used in this calculation. The basis used in the calculation is determined taking into account our experience and further adjustment factors may be applied with the aim of surrender value payments being equal to adjusted *asset shares* on average over the long term.

As for maturity and death claims, we may include an allowance for a policy's share of the current margin in the amount paid out, depending on the financial health of the *MSS Fund*.

Surrender bases are usually reviewed at least once in each calendar year. In stable conditions it may only be necessary to undertake a high level review of the adequacy of the basis.

#### 1.2.5 Smoothing policy

##### Maturity and death claims

There is no specific period over which the cost of *smoothing* is expected to be neutral. However all the assets of the fund must eventually be distributed to policyholders. When calculating adjusted *asset shares* a margin is held back to allow our *smoothing* policy to be operated.

When determining maturity payouts for classes of policy for which *asset shares* are calculated, we aim to pay between 75% and 125% of adjusted *asset share*, subject to paying a minimum of the guaranteed benefits. Payouts may fall outside this range in some circumstances, but we will ensure that when we set payouts we have good reason to believe that at least 90% of those payouts will fall within the range. To do this, we investigate sample policies that represent groups of underlying individual policies. This use of sample policies is consistent with our smoothing approach for setting *final bonus* rates. It results in less disparity between the payouts for individual policies within each sample group than if we assessed payout ranges using individual policies. For example, there would be less disparity between the return on premiums paid for policies with larger or smaller premium sizes within each sample group.

In addition to applying the above payout range, our aim is that in stable investment conditions the change in maturity value or death claim value from one year to the next for equivalent policies should not exceed 10%. Subject to this, for each term of policy considered we currently aim to equate payouts to 100% of adjusted *asset share* within three or four years. To do this we project both maturity values and adjusted *asset shares* over this period, and take the current and eventual target position into account in setting bonus rates.

Larger changes in value than 10% may be required from one year to the next following volatile investment conditions, significant changes in economic conditions, or in either periods of prolonged low investment returns or periods of prolonged high investment returns. Where possible, these larger changes will be achieved by implementing more frequent changes in *final bonus* rates, although it may be necessary for a particular change in value to exceed 10% in order to achieve the required full year change.

No limit has been set on the accumulated *smoothing* cost that is considered to be acceptable.

The same *smoothing* policy is applied to all generations of With Profits policies. There is no new business written in the fund, apart from a small number of premium increases or top-ups to certain categories of pension policy.

### Surrender and transfer values

When determining surrender and transfer payouts for classes of policy for which *asset shares* are calculated, we aim to pay between currently 75% and 125% of adjusted *asset share*, subject to paying any minimum amount guaranteed. Payouts may fall outside this range in some circumstances, but we will ensure that when we set payouts we have good reason to believe that at least 90% of those payouts will fall within the range. To do this, we investigate sample policies that represent groups of underlying individual policies. This use of sample policies is consistent with our smoothing approach for setting *final bonus* rates. It results in less disparity between the payouts for individual policies within each sample group than if we assessed payout ranges using individual policies. For example, there would be less disparity between the return on premiums paid for policies with larger or smaller premium sizes within each sample group.

There is no limit on the change in surrender or transfer value for equivalent policies from one year to the next. However large changes will only be implemented following significant changes in investment conditions.

*Final bonus* rates determined for maturity values are used directly in surrender value or transfer value calculations. These rates have already been *smoothed* in line with our current *smoothing* policy. However the full bases for these calculations are also

reviewed from time to time by investigating a range of sample policies. We aim to set surrender and transfer value bases so that over the long term surrender and transfer payments are on average equivalent to 100% of the adjusted *asset share*.

## 2. Investment strategy

### 2.1 Principles

#### 2.1.1. General

The assets of *the Society* identified as backing linked liabilities (e.g. unit-linked policies) are the linked assets. The remainder are the non-linked assets.

Since July 1997, the non-linked assets have been split into a *Non Profit Pool* and a *With Profit Pool*, in accordance with the *Merger Scheme*. The *Non Profit Pool* is established by matching specific fixed interest assets to the non-profit liabilities. The remainder of the non-linked assets form the *With Profit Pool*.

The majority of the non-linked assets are not formally segregated between the *MSS Fund* and the *Open Fund*. However, the *Merger Scheme* specifies that certain assets (the Own Assets) belong to the *Open Fund* only. These are predominantly investments in subsidiary companies, and fixed assets.

As required by the *Merger Scheme* the overall investment return earned on the *With Profit Pool* is then used to determine the overall investment return for both the *Open Fund* and the *MSS Fund*. Within the *MSS Fund*, asset allocation might vary between classes of policy. In the event that *Open Fund* asset allocation varies between different parts of that fund, the asset allocation for the *MSS Fund* will be the same as that for the *Open Fund* asset shares, except for the Own Assets.

The underlying principle is compliance with the *Merger Scheme*.

The overall investment strategy for the *With Profit Pool* is to maximise the investment return achieved by the assets, allowing for income and capital growth and the effects of taxation. This is subject to an acceptable level of risk and any actuarial constraints.

The main factors driving the strategy are:

- Risk will be managed by following a suitable diversification policy based on asset allocation guidelines.
- Actuarial modelling will be used to assess the overall risks to the *MSS Fund* and the *Open Fund* of different asset allocations with particular attention to guarantees within the liabilities. This will be a significant input into the asset allocation guidelines.
- This input will be used to help determine the equity content of the *With Profit Pool* which will, where appropriate, be above the industry average. Performance will therefore be dependent on the UK stockmarket and other major markets worldwide. This aim is subject to the constraints in 2.1.3 below. Publicly available information will be used to determine the unweighted average equity content of other life insurance companies from time to time.

We do not in general aim to buy *derivatives* or similar instruments as part of the investment strategy whilst our financial strength is sufficient to allow this approach. *Derivatives* might however be purchased to cover certain specific risks or where we determine that they provide a specific strategic advantage.

### 2.1.2. Non-traded assets

The *With Profit Pool* includes some assets that would not normally be traded. These include the Head Office building and the investments in subsidiary companies. However, investments in subsidiaries are not included in the assets backing the *MSS Fund*. These investments are of use as they allow *the Society* to achieve its strategic aims.

We do not impose any general liquidity or credit requirements on the non-traded assets.

### 2.1.3. Constraints on investment strategy

In addition to the considerations of risk mentioned in 2.1.1. our investment strategy may also be constrained by the need to treat With Profits policyholders fairly, which includes striking the right balance between achieving good returns for policyholders and maintaining solvency. We also set limits on our exposure to any one counterparty. For instance *the Board* sets limits on the amounts placed with any one deposit taking institution. These limits reflect the size and status of such institutions and are reviewed from time to time.

## **2.2 Practices**

### 2.2.1. General

*The Board* is responsible for setting our policy regarding the acceptable level of risk within the investment portfolios. This includes responsibility for the approval of any new or novel investment instruments.

The Executive Committee has responsibility for detailed monitoring of the investment parameters agreed by *the Board*. A Statement of Investment Principles is also maintained for each fund and the Executive Committee formally review this annually.

Specific assets are held for the Non Profit Pool and for the linked assets. Derivatives are held to match the liability arising from guaranteed annuity options on particular types of policy in the *MSS Fund*. These derivatives are held within the surplus assets of the *MSS Fund* so have no impact on asset share investment returns.

The investments currently permitted for the *With Profit Pool* are all listed and unlisted UK and international securities (e.g. equities, government and other fixed interest or index-linked stocks, convertibles, and warrants), unit trusts, OEICs, property, cash and other money market instruments, including *derivatives*. Any use of *derivatives* requires Board agreement.

The *With Profit Pool* will operate within asset allocation guidelines, which consist of maximum and minimum percentages for each asset type. These ranges and the position within the range are discussed in detail regularly at Executive Committee meetings and the actual asset allocations are published half-yearly on our website. Detailed strategies are adopted for investment in each of equity, property, cash and corporate bonds as set out below.

Our current policy regarding exercise of rights is to vote where appropriate, particularly in relation to contentious issues or where *the Society* has a significant stake in the company concerned.

### 2.2.2 Equity strategy

The main points of the equity strategy for the *With Profit Pool* are:

- The majority of investments are held over the long term rather than actively traded.
- The percentage of equities invested outside the UK is subject to an agreed range.
- Capital Gains Tax planning may influence decisions on sales of individual stocks.
- There is a short term equity sales plan in place which would operate at very low stock market levels, to safeguard solvency.

### 2.2.3 Property strategy

The main points of the property strategy for the *With Profit Pool* are:

- The majority of property investments are held over the long term rather than actively traded.
- When buying new properties we normally look to purchase high quality freehold or long leasehold assets let to strong covenants.
- Sales are considered where the unexpired term on a lease is relatively short or where it is felt that there are limited prospects for future growth or where an exceptional sale figure can be achieved, e.g. to a special purchaser.
- We seek to maintain diversity in our property holdings both by location and by type of property.

### 2.2.4 Cash strategy

The main points of the cash strategy for the *With Profit Pool* are:

- We normally invest in time deposits with a range of authorised borrowers.
- Most of our deposits are kept relatively short (up to 6 months) for cash management purposes.
- As well as Sterling, we also hold balances in other major currencies, often with a view to investing in equity and bond markets overseas when we feel the timing is appropriate.

### 2.2.5 Fixed interest strategy

The main points of the fixed interest strategy for the *With Profit Pool* are:

- The majority of fixed interest investments are held over the long term rather than actively traded.
- We focus almost entirely on corporate bonds with a credit rating of BBB- or better and Government backed securities.
- We invest selectively from new issues of bonds and trade in the secondary market in line with our long-term buy and hold strategy.

### 2.2.6 Non-traded assets

The only material asset that would not normally be traded is our Head Office building in Birmingham. This represents only a small percentage of the total assets. The Head Office building is included in the property portfolio, to which a suggested range is applied. The investment return earned on the Head Office building is included in the investment return on the *With Profit Pool*.

### 2.2.7 Other asset classes

The main points of the other asset classes strategy for the *With Profit Pool* are:

- The Society may invest in asset classes other than those listed in sections 2.2.2 to 2.2.6.
- Investment in such assets will generally be in line with our overall strategic approach.
- The Society currently has relatively modest exposure to other asset classes – mainly infrastructure and private equity.
- Our investment in other asset classes will normally be achieved through investing in some form of investment trust or other pooled fund.



### 3. Business risk

#### 3.1 Principles

The *MSS Fund* is operated in accordance with the *Merger Scheme*. This scheme contains provisions which ensure that the *MSS Fund* is not exposed to any business risks arising from other business activities of *the Society*. The only business risks to which it is exposed are those arising from policies in the *MSS Fund* itself, except as stated below. These include guarantees, *Guaranteed Annuity Rates (GARs)* and other policy options, and compensation arising from the sale of policies issued by Medical Sickness before the merger with Wesleyan in accordance with the *Merger Scheme*.

The *MSS Fund* receives 50% of the profit arising from a reinsurance treaty for income protection business set up shortly before the merger with Wesleyan. This treaty covers income protection business in both the *MSS Fund* and the *Open Fund*. All profit share amounts received under this treaty are credited to the *MSS Fund*. In addition there is an arrangement specified in the *Merger Scheme* under which 50% of the profits arising from the income protection business transferred to the *Open Fund* (after allowing for reinsurance) are credited to the *MSS Fund*. Under both arrangements, any losses are carried forward and offset against future profits.

#### 3.2 Practices

The operation of the *MSS Fund* as described in this document ensures that the above Principles are followed. The profits and losses arising from risks to which the *MSS Fund* is exposed are spread across all policies in the fund via regular adjustments to *asset shares* or to the margin as described in section 1.2.1.1, regardless of the size of those profits or losses.

These adjustments are made as soon as a future profit or loss is recognised, based on calculations approved and certified by the *Actuary*. Where an estimate or actuarial calculation is required (for instance, the *guarantee costs* which depend upon future investment returns) the cost is calculated by the *Actuary* on the basis of the best available knowledge and judgement.

*Guarantee costs* and costs of *GARs* are based on calculations that allow for the full range of possible outcomes.

The *MSS Fund* is exposed to morbidity and mortality risks. It is also exposed to the risks arising from persistency (i.e. the rate at which policies lapse or are surrendered), from guarantees we provide in policies and from our *smoothing* policy.

Other risks arise from:

- falls in stock markets or the value of individual investments;
- the failure of reinsurers or other suppliers;
- the inability to sell investments easily for cash;
- weaknesses in internal controls over our operations; and
- costs in excess of those anticipated, except where a guarantee applies.

## 4. Charges and expenses

### 4.1 Principles

The *Merger Scheme* specifies the items of expenditure that may be charged to the *MSS Fund*. The expenses are charged to with profit policies in the *MSS Fund* to reflect the costs of administering the policies plus an appropriate share of overheads.

In addition a charge is made to the *MSS Fund* for the investment support received from the *Open Fund*. The amount of this charge each year, which gradually increases to 0.75%p.a. of the value of the *MSS Fund* in 2013, is specified in the *Merger Scheme*.

Changing the method of allocation of expenses to the *MSS Fund* is only possible if the *Merger Scheme* is amended. High Court approval is necessary for such a change to be made.

### 4.2 Practices

The types of expense that are charged to the *MSS Fund*, as specified in the *Merger Scheme*, are as set out below.

- The salary of each member of staff (excluding support staff and investment staff) who works on any matter relating to MSS with profit policies is charged to the *MSS Fund*. Salaries for staff spending part of their time working on MSS With Profits policies are charged proportionately. Related overheads such as pension costs, NI contributions, rent and stationery costs are allocated in the same proportion as the salaries.
- The salaries and related overheads of support staff (but not investment staff) are allocated between the *MSS Fund* and the *Open Fund* in proportion to the allocation of salaries described above.
- The proportion of information technology costs (including running costs, depreciation and maintenance costs) that relates to MSS With Profits policies is estimated and charged to the *MSS Fund*.
- Investment costs are allocated to the *MSS Fund* in proportion to the funds under management.
- Other costs incurred solely in respect of MSS With Profits policies, such as bonus statement production, are charged directly to the *MSS Fund*.
- A fair allocation of costs incurred partly in respect of MSS With Profits policies, such as the production of annual reports, is charged to the *MSS Fund*.

To ensure a fair allocation of the expenses above across the policies in the *MSS Fund*, an internal reinsurance arrangement is in place between the *MSS Fund* and the *Open Fund*. By respreading the expense charges projected to arise in the future the agreement ensures that the expenses charged to each policy will not rise unfairly. It also sets the increase in the level of the expenses to be charged to the *MSS Fund* for administration of each policy in line with a defined formula, so the *Open Fund* now carries the risk that these expenses will be larger than expected.

Two-thirds of any costs associated with purchasing specific assets to reduce the risks arising from guarantees or options on particular types of contract are met by the *MSS Fund*, with the other one-third being met by the *Open Fund's* estate.

The expenses charged to the *MSS Fund* are charged to *asset shares*

There are no material outsourcing agreements in place.

## **5. Management of the estate**

### **5.1 Principles**

The operation of the *MSS Fund*, including bonus policy, is overseen by the *Monitoring Committee* and certified by the *Actuary*, as set out in the *Merger Scheme*.

Bonuses must be declared such that the whole of the surplus in the *MSS Fund* is progressively and equitably distributed to the policies in that Fund. Therefore the *MSS Fund* is operated without an estate.

In the event that the *MSS Fund* was unable to pay its guaranteed liabilities, support would be provided by the *Open Fund*.

### **5.2 Practices**

The *Credit Balance* of the *MSS Fund* is calculated at the end of each calendar year, as specified in the *Merger Scheme*, and, after deducting a margin as described in section 1.2.1.1, is compared with the aggregate of the *asset shares* of policies in the fund. This results in adjustments to the *asset shares*. In this way, the *MSS Fund* is run without an estate.

## **6. New business volumes**

### **6.1 Principles**

No new business is written in the *MSS Fund* other than some increases in premiums under certain existing pension policies. The circumstances in which these increases are allowed are set out in the *Merger Scheme*.

## **7. Shareholders**

### **7.1 Principles**

Wesleyan Assurance Society is a mutual organisation with no shareholders.

## Glossary

<i>Actuary</i>	<p><i>The Society's</i> Actuary as defined in our rules. Under PRA and FCA rules, <i>the Society</i> is required to appoint a With Profits actuary and a Chief Actuary. The With Profits actuary provides advice to <i>the Society</i> on the operation and management of its With Profits business and the exercise of discretion. The Chief Actuary advises <i>the Society</i> on the risks that it faces and on the amount of capital required to support the business. These two roles may be undertaken by the same person advising <i>the Society</i> in different capacities. Any reference to Actuary in the text means the more appropriate of these two roles.</p>
<i>Annual bonus(es)</i>	<p>Bonuses which are added each year to With Profits policies to increase the guaranteed benefits payable.</p>
<i>Annuity</i>	<p>A series of regular payments made to a policyholder for a specified period of time: for example, until death.</p>
<i>Asset share(s)</i>	<p>A measure used as a guide to a policy's fair share of the fund, calculated as described in section 1.2.1.1.</p>
<i>The Board</i>	<p>The Board of Directors of Wesleyan Assurance Society.</p>
<i>Credit Balance</i>	<p>The amount of the <i>MSS Fund</i>, representing its share of the value of the assets in the <i>With Profit Pool</i>.</p>
<i>Derivatives</i>	<p>Financial instruments, the prices of which are directly dependent upon the value of one or more underlying securities. They are often used to hedge risk or to exchange a floating rate of return for a fixed rate of return.</p>
<i>Final bonus(es)</i>	<p>A bonus which is added to a policy when it becomes a claim. Final bonus rates are not guaranteed.</p>
<i>Guaranteed Annuity Rates (GARs)</i>	<p>A guaranteed minimum rate at which a retirement fund built up under a pension policy is converted to an annuity.</p>
<i>Guarantee costs</i>	<p>The costs arising from any minimum benefits guaranteed to With Profits policyholders.</p>
<i>Medical Sickness Society</i>	<p>Medical Sickness Annuity and Life Assurance Society Limited. This company merged with Wesleyan in 1997.</p>

<i>Merger Scheme</i>	<p>A Scheme approved by the Court, which sets out how the merger of Wesleyan with <i>Medical Sickness Society</i> on 1 July 1997 should take place and how the <i>Open Fund</i> and the <i>MSS Fund</i> should be managed thereafter.</p> <p>The current interpretation of the Merger Scheme is described in the PPFM. If there are any changes to this interpretation then compliance with the <i>Merger Scheme</i> takes precedence.</p>
<i>Monitoring Committee</i>	A committee established under the terms of the <i>Merger Scheme</i> to monitor and report to <i>the Board</i> on the operation of the <i>Merger Scheme</i> as it applies to the <i>MSS Fund</i> .
<i>MSS Fund</i>	A closed fund set up under the terms of the <i>Merger Scheme</i> . It contains all the with profit policies of <i>Medical Sickness Society</i> in-force on that date and is maintained as a separate account within the Wesleyan's Long Term Business Fund.
<i>MSS non-profit business</i>	Non-profit policies sold by <i>Medical Sickness Society</i> prior to the merger with Wesleyan. As a result of the merger these policies became part of the <i>Open Fund</i> .
<i>Non Profit Pool</i>	A subset of the assets of the <i>Open Fund</i> chosen to match the nature and term of the non-profit liabilities as closely as reasonably practicable.
<i>Open Fund</i>	The Wesleyan Long Term Business Fund, excluding the <i>MSS Fund</i> .
<i>Smoothing</i>	Smoothing is an important and fundamental aspect of With Profits policies, allowing policyholders to benefit from investment in the stock market, but with the short-term highs and lows evened out.
<i>The Society</i>	Wesleyan Assurance Society.
<i>With Profit Pool</i>	The group of assets that back <i>the Society's</i> With Profits business, as described in section 2.1.1.