A GUIDE TO INVESTING IN GUARDIAN ASSURANCE'S WITH-PROFITS FUND

Guardian Assurance plc, Guardian Linked Life Assurance Ltd and Guardian Pensions Management Ltd;
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Registered in England (Nos 38921, 1397655 and 985480). All are authorised and regulated by the Financial Services Authority.

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Glossary

1. Introduction

In this guide we explain the principles and practices of investing in our with-profits fund and how we manage the money invested in the with-profits fund. You should read it in conjunction with our Principles & Practices of Financial Management (PPFM), which appear on our website (www.guardianfs.co.uk). Alternatively, copies of the PPFM can be obtained on request from:

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This guide is issued to all policyholders who are either invested in our with-profits fund or have a policy that allows them to switch their investment into our with-profits fund including policyholders with Countrywide Assured plc whose with-profits business is reassured into our with-profits fund. This guide is also available on our website (www.guardianfs.co.uk).

The PPFM is split into two sections: Principles and Practices. The Principles set out our general approach to the management of with-profits business and are not expected to change often. If we propose to make any changes to the Principles then we will give you advance notice of the changes. The Practices contain details relating to the day-to-day operation of our with-profits business within the Principles framework. If we make any changes to the Practices then we will notify you within 12 months of the changes.

If, when you have read this guide, you have questions about retaining an existing with-profits policy or investing in with-profits you should seek further advice from your financial adviser. If you do not have a financial adviser, IFA Promotion Ltd will be able to give you information about some Independent Financial Advisers in your area. You can visit their website at www.unbiased.co.uk or call them on 0800 085 3250. If any factual information would be helpful, please contact the With-Profits Actuary at the address given above.

Explanations of words and phrases highlighted in bold are given in the Glossary at the back of this guide.

2. Background

Guardian Assurance plc can trace its history back to 1821 when the Guardian Fire and Life company was formed. In 1901 Guardian Fire and Life company was re-branded as Guardian Assurance and in 1968 Guardian Assurance merged with another life office - the Royal Exchange. In 1970, 5 Life Funds (Guardian, Royal Exchange, Atlas, Caledonian and Licences and General) of the combined group were merged to form the with-profits fund ("the **Fund**") of Guardian Assurance plc.

The **Fund** contains both with-profits and **non-profit business** including unit-linked business. The with-profits policyholders receive 90% of the profits arising in the **Fund** and the **shareholder** receives 10% of the profits. Our ultimate **shareholder** is AEGON nv, a large multinational insurance group based in The Netherlands.

In 1998 the **Fund** was restructured and became closed to new business. As part of the restructure the **Fund** received a cash injection from the then shareholder in return for 70% of the future profits arising on the major classes of unit-linked business written in the **Fund**. The cash injection was invested in the **Fund**. The shareholder continues to receive 70% of the relevant profits as they arise.

Since the **Fund** became closed to new business, the **estate** held within the **Fund** is no longer required as working capital and is being distributed gradually to the with-profits policyholders by way of higher bonus rates than would otherwise have been the case. Only with-profits policies that were in-force at the time of the announcement of the restructure benefit from the distribution of the **estate**.

All with-profits contracts offer a guaranteed rate of return. The rate varies by type of with-profits contract and over the years the **Fund** has written a large variety of with-profits contracts as described below. Note that any references to guarantees are in the context of the specific points in time where guarantees may apply (e.g. maturity, death, retirement at selected retirement date, regular income withdrawals, withdrawals at a specific anniversary). Guarantees do not generally apply on early surrender.

3. The main classes of with-profits business

<u>Pension Plus, Versatile Individual Pension Plan and Buy-Out Plan</u>
These are annual or single premium deferred annuities with a guaranteed cash option at the normal retirement date. Current interim **annual bonus** rates are 0.5%. No **terminal bonus** is currently paid on the majority of this class of business. This is likely to remain so in the future as the value of the guaranteed annuities exceed **the asset share** by a significant amount. Bonus rates are not guaranteed. Guaranteed rates of return on offer at outset were typically in the range 1.75% p.a. to 7.75% p.a.

<u>Personal Pension and Participating Pension</u>
These are deferred annuities with a guaranteed cash option. Policies are written to age 70 but have guaranteed early retirement terms from age 60. Current interim **annual bonus** rates are 1.0%. Bonus rates are not guaranteed. Guaranteed rates of return on offer at outset were typically less than 3.5% p.a.

Life Assurances

These are endowment and whole of life assurances. The majority are simple bonus contracts but there is also an older compound bonus series. Current interim **annual bonus** rates are 1.0% for both simple and compound bonus. Bonus rates are not guaranteed. Guaranteed rates of return on offer at outset were typically less than 0.5% p.a.

Chargeable Rates

This is a group pension scheme contract with a guaranteed cash option. Bonus rates are fully allowed for in the **premium rates** on the basis of investment in fixed interest securities. The current **annual bonus** rate is 2.6% and the **terminal bonus** rate is 10%.

Freedom Unitised With-Profits

These are unit-linked with-profits contracts where benefits are expressed in the form of the accumulation of notional units allocated to a contract. Unit values are guaranteed (i.e. the with-profits unit price cannot go down) though a **market level adjustment** may apply on early surrender. Unit prices increase daily at the current bonus interest rate, which is not guaranteed. The current bonus interest rate is 1.25% p.a. and the unit price is guaranteed not to fall.

Choices Unitised With-Profits

These are unit-linked with-profits personal pensions where benefits are expressed in the form of the accumulation of notional units allocated to a contract. The bonus structure is the same as Freedom above except that the unit price is increased by basic interest and bonus interest. The current basic interest rate is 0.5% p.a. and the current bonus interest rate is 1.0% p.a. The rates are not guaranteed and a **market level adjustment** may apply on early surrender. The unit price is guaranteed not to fall.

Deposit Administration

Deposit Administration is a group scheme deposit-type contract where benefits are expressed in the form of an accumulating fund. The contract is backed by fixed interest securities and bonus rates are declared for each past year of deposit, based on the redemption yields of 15-year **gilts** at the time of deposit. For the purposes of determining bonus rates after 15 years deposits are notionally reinvested. The amount of deposit is guaranteed not to fall.

Pension Saver

This is a group scheme contract similar to Deposit Administration, except that only one bonus interest rate is declared, based on a weighted average of the amount of premium invested in each past year and the redemption yield available on 15-year **gilts** at the time of investment. For early deposits notional reinvestment after 15 years is assumed. The amount of deposit is guaranteed not to fall.

4. What is a with-profits policy?

A with-profits policy provides a minimum guaranteed benefit plus a share in the performance of the with-profits fund through a system of bonuses. In deciding the bonuses, we smooth out some of the fluctuations in performance over the term of your investment. This is commonly referred to as smoothing of returns. Although we smooth investment returns our aim is to pay out all of the investment profits (or losses) earned by the fund over the long term. The allocation of the investment returns of the with-profits fund varies by class of business and also depends on when a policy commenced. If the allocated investment return is less than the rate of return implicit in any guaranteed benefit then no bonus may be payable.

If you invest in the with-profits fund your money is pooled with that of other investors in the fund. This works in much the same way as any other pooled fund (such as a unit trust). The with-profits fund invests in a mix of company shares (equities), fixed interest securities (for example, loans to the Government or large corporations) and cash. These different types of investment are known as classes of assets.

5. When do the guarantees apply?

Generally the guaranteed benefit is only applicable if you hold your policy, and continue to pay your premiums, for the whole term of your policy. However, Personal Pension & Participating Pension policies are written to age 70 but have guaranteed early retirement terms from age 60 onwards. In addition, for Choices unitised with-profits business there is a guarantee that the **market level adjustment** will not be applied provided pension benefits are taken no earlier than 5 years prior to the normal retirement date selected at outset of the policy.

6. What if I decide to cash-in my policy?

If you decide to cash-in your policy early then the payment you will receive is not guaranteed and may be less than the benefit offered at outset. An element of **terminal bonus** may be included in the surrender value. For Freedom and Choices unitised with-profits contracts a **market level adjustment** may apply on early surrender.

If you do decide to cash-in your policy, also known as surrendering your policy, then the approach to ensuring you receive your fair share of the total fund growth is described below in section 9.

7. What types of bonuses may be added to my policy?

Bonuses are the means by which we pay your share of the investment profits of the with-profits fund. There are 2 main types:

- **Annual bonuses** (also known as regular bonuses or reversionary bonuses) which when added to policies, constitute additional guarantees at specific points in time as per the Policy Conditions. **Annual bonuses** under all classes, other than Freedom and Choices, are declared in arrears, usually once a year on 31 December. Interim bonus may be paid on a policy that matures or has a claim part way through the year. It is paid to bring bonuses up to date. **Annual bonus** rates under the Freedom and Choices classes are declared usually once a year on 1 April, but may be changed at other times during the year.

- **Terminal bonuses** may be paid at our discretion when there is a claim under your policy, for example, when you cash-in your investment or reach the end of your investment term. Surrender values paid on early termination of the contract are generally not guaranteed. An element of **terminal bonus** may be included in the surrender value. For Freedom and Choices unitised with-profits contracts a **market level adjustment** may apply on early surrender.

Details of how we calculate **annual bonuses, terminal bonuses,** surrender payments and **market level adjustments** are given below.

8. How are the annual bonuses that are added to my policy determined?

Different rates of **annual bonus** apply to the different with-profits contracts as detailed in section 3. For other than Deposit Administration, Pension Saver and Chargeable Rates, the rates were reduced at 31st December 2004 to such a level that no further reductions are planned. The investment strategy is consistent with the intention of not reducing **annual bonus** rates further - as outlined in section 10 below.

If future investment returns are significantly better than expected then **annual bonuses** will not be increased but terminal bonus rates will be increased above those that would have otherwise applied. **Annual bonus** rates would be reduced if future returns are significantly worse than expected or as required by the **Overriding Principle** set out in the PPFM.

Deposit Administration and Pension Saver **annual bonus** rates are set by reference to **gilt** yields. Chargeable Rates bonus rates are set by reference to the **premium rates** and fixed interest yields.

9. How do we calculate terminal bonuses, surrender payments and market level adjustments (MLAs)?

Asset shares are fundamental to the way in which we determine **terminal bonuses,** surrender payments and **MLAs.** **Asset shares** represent the accumulation over time of premiums paid less a variety of deductions (e.g. contract charges and/or expenses, costs of life cover and other benefits, tax). The rate of accumulation used to calculate **asset shares** is consistent with the return earned on the assets in which premiums are deemed to be invested.

Enhancements may be made to **asset shares** in respect of the profits earned by the **Fund** from **non-profit business** written within the **Fund,** e.g. term assurance and annuity business. Enhancements to **asset**

shares may also be made in respect of the distribution of the **estate** held within the **Fund**. Only with-profits policies that were in-force at the time of the announcement of the restructure benefit from the distribution of the **estate**.

Deductions may also be made to **asset shares** in respect of the cost of guarantees provided and costs for the use of capital. Currently no deduction is made for the cost of guarantees nor for the use of capital as such costs are met by the **estate**. This is expected to continue into the future subject to the **Overriding Principle** set out in the PPFM.

Terminal bonus varies between the different with-profits contracts described in section 3. **Terminal bonus** is not payable on Deposit Administration and Pension Saver contracts. For Freedom and Choices contracts a different **terminal bonus** rate applies to each past year's unit holding. E.g. A rate for units purchased in 1999, a rate for units purchased in 2000 etc. For other with-profits classes, a **terminal bonus** scale is set separately for each class of business and for most classes the **terminal bonus** rates vary depending on the year the policy was taken out.

Terminal bonus rates depend upon the relationship at maturity between the **asset share** and the guaranteed benefits, the excess of **asset share** over guaranteed benefit providing the scope for a **terminal bonus.** It is important to note that this relationship is not measured at an individual contract level, but by reference to groups of contracts with similar characteristics. For example, we would normally group together contracts of a particular class of business that were taken out in the same year. If **asset shares** exceed guaranteed benefits at maturity then a **terminal bonus** will generally be paid. Otherwise, no **terminal bonus** will generally be paid. Hence we aim to pay on average 100% of **asset share** on maturity, and may pay more than this if the guaranteed benefits exceed the **asset share.**

Benefits payable on early surrender are not guaranteed. For Freedom and Choices contracts the unit value plus **terminal bonuses** may be subject to a **MLA** on early surrender. The **MLA** ensures that the surrender value does not exceed the underlying **asset share** of the policy. For other with-profits contracts, the benefits payable on surrender are based on the **asset share** for groups of contracts with similar characteristics. For deferred annuity contracts the surrender benefit available may be in the form of annuity. For groups of contracts with similar characteristics, if the likely future cost of the guaranteed benefits is higher than the **asset share** then surrender benefits may be greater than corresponding **asset share.** Hence we aim to pay on average 100% of **asset share** on surrender, and may pay more if the value of the accrued guarantee benefit exceeds the **asset share.**

Terminal bonus rates are reviewed annually and set at a level so that, for groups of similar policies, broadly 100% of **asset share** is paid at maturity. Under current practice this review is undertaken each April. Rates are then normally reviewed monthly during the year, but normally only changed if the **asset shares** for groups of policies are less than 95% of the maturity values or more than 105%. A similar practice is adopted with respect to the benefits payable on early surrender. **Terminal bonus** rates are changed without notice and may also be zero for certain classes and durations. Similarly, the benefits payable on early surrender are changed without notice.

10. What is our investment strategy for the with-profits fund?

Currently the assets of the **Fund** are mainly invested in UK equities and fixed interest securities. This may change in line with the Investment Principles set out in the PPFM.

The **Fund** adopts a close matching philosophy. The fixed interest portfolio is invested with the objective that the projected cash flows from the portfolio match, both in terms of size and timing, the guaranteed with-profits liabilities, such as **basic sums assured**, accrued **annual bonuses**, as well as expected future **annual bonuses**. The same applies for the **non-profit business** within the **Fund**, such as annuities in payment. This protects the **Fund** from strains arising from interest rate movements and also makes the future **annual bonus** rates largely immune to changes in interest rates. The **Fund** is not, however, protected against significant levels of default on corporate bond holdings.

Benefits which are not guaranteed, such as accrued **terminal bonus**, are generally backed by UK equities. For with-profits pension policies where no **terminal bonus** can be afforded, the investments backing the **asset share** will be entirely fixed interest securities.

The assumed **equity backing ratio** for with-profits assets varies from class to class and also by duration within each class reflecting the close matching philosophy adopted. Rates applicable at June 2007 were:

Pension Plus, Versatile Individual Pension Plan
and Buy-Out Plan - 0% to 20%.
Personal Pension and Participating Pension - 0% to 30%.
Life Assurance business - 25% to 55%.
Unitised with-profits business - Life - 20% to 60%.
Unitised with-profits business - Pensions - 40% to 75%.
Chargeable Rates, Deposit Administration and Pension Saver - 0%

These ratios may vary from time to time. A table of the above **equity backing ratio** by policy class is available in the **Firm's** website and will be updated every 3 months. Any significant change in asset mixes will be communicated separately to policyholders.

11. How do we manage the estate?

The intention is to distribute the **estate** equitably to the with-profits policies in-force at the time of the announcement of the **Fund's** restructure in accordance with the **Overriding Principles** set out in the PPFM. The distribution of the **estate** is achieved by using **Bonus Surplus** to enhance **asset share** returns.

The **estate** provides capital support towards meeting **regulatory solvency requirements** and is used to meet the cost of guarantees (which includes meeting the excess when more than the **asset share** is paid out), the cost for the use of capital and any smoothing costs. Any compensation or redress in connection with the way business written in the **Fund** has been marketed or sold is also met by the **estate.**

The transfer out of the **Fund** of the **shareholder's** share of the profits arising in the **Fund** results in additional tax being payable. This additional tax is met by the **estate** whereas prior to 30th June 2005 it was charged directly to **asset shares.**

12. What are the other relevant issues?

There are a number of additional issues that are relevant to the operation of our with-profits business:

- All normal management and administration expenses, other than investment expenses, are met by the **shareholder** through the **shareholder**-owned service company AEGON UK Services Limited, and the **Fund** pays the **shareholder** an agreed level of expenses based on the number of policies in-force.

- The **Fund** pays an agreed annual management charge to the **shareholder** for investment management services. As at 1st January 2005, the level of charge being made, as a percentage of the assets under management was 0.075% per annum.

- The **Fund** no longer writes new business but is legally obliged to accept incremental business and the exercise of options on certain life and pension policies. The risks of writing such business are reduced as generally the terms on which it is accepted can be varied by the **Fund** at any time.

- Certain existing business risks have been identified and appropriate reserving has been put in place. Any currently unrecognised business risks could impact on future returns to with-profits policyholders. This would depend on the nature of any such risks and their size.

- Under the terms of the **Fund** restructure in 1998 the cost of certain guarantees were retained by the **Fund.** In particular, the cost of a Maturity Guarantee under a unit-linked contract written by Guardian Linked Life Assurance Ltd and the cost of Guaranteed Annuity Options on two unit-linked Group Schemes written by

Guardian Pensions Management Ltd were both retained by the **Fund.**

- It was established at the time of the **Fund's** restructure that the **Fund** has no Orphan Estate.

Glossary of Terms

Annual Bonuses: Amounts, which when added to policies, constitute guarantees at specific points in time as per the Policy Conditions. Bonus rates are normally reviewed annually.

Asset Shares: **Asset shares** represent the accumulation over time of premiums paid less a variety of deductions (e.g. contract charges and/or expenses, costs of life cover and other benefits, tax). The rate of accumulation used to calculate **asset shares** is consistent with the return earned on the assets in which premiums are deemed to be invested. **Asset shares** are used as a guide to setting bonus rates.

Basic Sum Assured: An amount guaranteed at the outset of a policy to be paid at specific points in time in accordance with the Policy Conditions at the point of payment of a premium or a series of premiums.

Bonus Surplus: Bonus Surplus is an addition to the assumed **asset share** investment return to credit the **asset share** with the distribution of the **estate** and other sources of miscellaneous profits or losses earned by the **Fund**, such as profits or losses earned by the **Fund** on **non-profit business** or the difference between actual and assumed investment returns. In principle, because the with-profits policyholders share in all the profits or losses of the **Fund** the Bonus Surplus addition could be negative e.g. if the cost of the guarantees was significantly greater than anticipated or a currently unrecognised significant Business Risk emerged.

Estate: The excess, on a realistic basis, of assets within the **Fund** over and above the amount required to meet liabilities.

Equity Backing atio (EBR): The proportion of assets invested in equities.

Firm: Guardian Assurance plc.

Fund: The Firm's long-term insurance fund into which with-profits and **non-profit business** is written.

Gilts: Fixed interest securities issued by the UK Government.

Market Level Adjustment (MLAs): A reduction in the value of units under a unitised with-profits policy that may apply when a claim arises at a point where no guarantee exists.

Non-profit business: Policies which do not share in the distribution of profits of the **Fund,** such as unit-linked policies, term assurance policies and annuities in payment.

Overriding Principle: The overriding principle that the **Firm** seeks to apply (subject to regulatory and legal requirements as interpreted and established from time to time) in determining annual and final bonus rates and **market level adjustments** (MLAs) is to maintain equity between different classes and duration of policyholders ("the **Overriding Principle**"). Bonus declarations are made at the absolute discretion of the Board.

When determining annual and final bonus rates and MLAs from time to time in accordance with the **Overriding Principle**, we shall have regard to **asset shares** and the other matters and provisions described in the PPFM. The concept of **asset shares** does not, however, represent policyholder entitlement but is a guide to meeting the objective that bonus declarations, from time to time, accord with the **Overriding Principle**.

Premium rate: The rate which determined how much initial guaranteed benefit was given at the outset of the policy for a given premium.

Regulatory Solvency Requirements: The minimum excess of assets over liabilities that must be maintained in accordance with the requirements of the Financial Services Authority.

Shareholder: AEGON nv, a large multinational insurance group based in The Netherlands.

Terminal Bonuses: Non-guaranteed amounts that may be added to guaranteed benefits (including **annual bonus** additions) when a claim arises.