PRINCIPLES & PRACTICES OF FINANCIAL MANAGEMENT OF WITH-PROFITS BUSINESS

DECEMBER 2011

GUARDIAN ASSURANCE Ltd

Guardian Assurance Ltd, Guardian Linked Life Assurance Ltd and Guardian Pensions Management Ltd;
Registered Office: Ballam Road, Lytham St Annes, Lancashire FY8 4JZ.
Registered in England (Nos 38921, 1397655 and 985480). All are authorised and regulated by the Financial Services Authority.

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Guardian Assurance Ltd
1. Introduction

1.1 The document has been prepared in accordance with the requirements of Chapter 6 of the FSA's Conduct of Business Sourcebook and details the Principles & Practices of Financial Management (PPFM) of With Profits business adopted by Guardian Assurance Ltd as at 31st December 2011.

1.2 The purpose of the document is to help further the understanding of current and potential with profits investors and their financial advisers as to the way in which Guardian Assurance Ltd (the "**Firm**") manages its with profits business including that accepted by way of reassurance from Countrywide Assurance plc and provide details on the governance procedures for such business.

1.3 If any changes are proposed to the Principles, with profits policyholders will be notified in writing three months in advance of the effective date of the proposed changes. If any changes are made to the Practices, policyholders will be notified within 12 months of the effective date of change.

1.4 An annual report will be produced by the **Firm** confirming whether, throughout the financial year to which the report relates, the **Firm** believes it has complied with the PPFM and setting out the reasons for that belief. The first such report was produced in 2006 in respect of the 2005 calendar year.

1.5 Annexed to the report detailed in 1.4 will be a report from the **Firm's With Profits Actuary** as to whether, in his opinion and based on the information and explanations provided to him by the **Firm**, the report detailed in 1.4 and the discretion exercised by the **Firm** over the period in question have taken into account the interests of with profits policyholders in a reasonable and proportionate manner. The first such report was produced in 2006 in respect of the 2005 calendar year.

1.6 In accordance with the **Firm**'s governance arrangements the With-Profits Committee provide an element of independent judgement in the ongoing assessment of compliance with the PPFM.

1.7 Further information can be obtained from Guardian Assurance Ltd, Ballam Road, Lytham St Annes, Lancashire, FY8 4JZ

1.8 Explanations of words and phrases highlighted in bold are given in the Glossary at the end of the document.

Guardian Assurance Ltd
2. Variation Provision

2.1 The Directors believe that the Principles should not, normally, vary in the short term as they set out the general approach to the management of with profits business. The Practices cover more detailed points and may vary more frequently. Notification of any variations to Principles or Practices will be given in accordance with requirements applicable from time to time.

2.2 Notwithstanding the foregoing:

2.2.1 The Directors expressly reserve the right to vary the Principles and Practices at any time if appropriate in order to achieve any of the following - to maintain the financial solvency of the **Fund**, to meet legal or regulatory requirements as identified or applied from time to time, or otherwise to maintain equity amongst different categories or generations of with profits policyholders in the changed circumstances that may prevail from time to time.

2.2.2 The Directors are obliged at all times to manage the with profits business of the **Firm** in accordance with the Memorandum and Articles of Association of the Company.

2.2.3 The Directors are obliged to give effect to legal and regulatory requirements as they apply to the **Firm** in a way that meets those requirements.

Guardian Assurance Ltd
3. Principles of Financial Management of With Profits Business

3.1 General

3.1.1 The with profits **Fund** of Guardian Assurance Ltd ("the **Fund**") contains both with profits and non-profit life and pension business. The with profits policyholders receive 90% of the profits arising in the **Fund** and the **shareholder** receives 10% of the profits.

3.1.2 In 1998 the **Fund** was restructured and became closed to new business. Since this date 70% of the profits arising on the major classes of unit-linked business written in the **Fund** are reassured to other shareholder-owned companies within the Guardian group. The **Fund** received a cash injection, in return for these reassured profits, which was invested in the **Fund**.

3.1.3 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, as the business declines. Only with profits policies that were in-force at the time of the announcement of the restructure benefit from the distribution of the **estate**.

3.1.4 In addition to the **shareholders'** 10% interest in the **Fund**, there exist investment and expense management agreements. The **investment manager** Kames Capital receives an annual management charge in return for managing the investments of the **Fund**. The **shareholder** provides all other administrative services to the **Fund** in return for an expense allowance that is based on unit cost levels in the base year of the agreement, plus an allowance for expense inflation which is related to **RPI**.

3.1.5 **'Firm'** in this document refers to Guardian Assurance Ltd.

3.2 The Amount Payable under a With Profits Policy

3.2.1 Amounts payable under with profits policies are guided by the calculation of "**asset shares**" (see 4.2).

3.2.2 To the extent considered appropriate, the investment returns that underpin the calculation of **asset shares** may be adjusted for expected costs of guarantees and costs for the use of capital. Asset share returns may be enhanced by **Bonus Surplus**.

3.2.3 Consistent with the concepts of pooling and **smoothing**, bonus rates are not set by reference to individual policy **asset shares**, rather by reference to the **asset shares** of groups of individual policies with similar characteristics (e.g. by in-force duration to the last whole year).

3.2.4 The methods used to set payouts to policyholders aim to ensure that payouts represent fair value in relation to the investment return achieved, the risks borne by the **Fund** and the characteristics of the policy type.

3.2.5 Any changes to the methods used to set payouts require the approval of the Board.

3.2.6 No changes would normally be made to any historic assumptions or parameters underpinning the calculation of **asset shares**, unless an error in such assumptions or parameters was subsequently discovered. However, future changes many be appropriate on account of, for example, developments in actuarial techniques, enhanced systems capabilities or legal judgements or to take into consideration tax assessments when finalised.

3.2.7 The Practices contain details of the approximations underpinning the calculation of the amounts payable to with profits policyholders. Examples of such approximations would be the application of monthly (rather than daily) investment returns in the calculation of **asset shares** and the grouping together of policies with similar characteristics in determining affordable **annual bonuses**, **final bonuses** and **market level adjustments**. Any approximations are applied consistently and are intended to have a broadly neutral effect over time and within product type.

3.3 Overriding Principle

3.3.1 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, terminal & final bonus** rates and **market level adjustments (MLAs)** is to maintain equity between different classes and durations of policyholders ("the Overriding Principle"). Bonus declarations are made at the absolute discretion of the Board.

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

3.4 The Approach to setting Annual Bonus Rates

3.4.1 The general approach to setting **annual bonus** rates is to project current **asset shares** to maturity, assuming estimates of future investment returns. These projections can be used to ascertain if **annual bonus** rates are supportable in the future.

3.4.2 Different rates of **annual bonus** apply depending on the characteristics of the individual classes of business written by the **Firm** (e.g. guaranteed growth rates, investment mix, tax).

3.4.3 For other than Deposit Administration, Pension Saver and Group Funding, the annual bonus rates were reduced at the 31st December 2004 declaration to such a level that no further reductions are planned. The investment strategy is consistent with the intention of not reducing annual rates further - as outlined in 3.7 below.

3.4.4 If future investment returns are significantly better than expected then **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 Principles.

3.4.5 Deposit Administration and Pension Saver **annual bonus** rates are set by reference to gilt yields as outlined in the Practices. Group Funding bonus rates are set by reference to the **premium rates** and fixed interest yields as outlined in the Practices.

3.4.6 The same rate of **annual bonus** normally applies to all policies within a class irrespective of when policies were taken out. Differences between generations are dealt with, where possible, through the **terminal bonus** structure and/or **MLA**. This could change if the **asset shares** of particular **cohorts of policyholders** were low relative to their **guaranteed benefits**. In such a circumstance, it could be appropriate for lower **annual bonus** rates to apply to that cohort.

3.5 The Approach to setting Terminal Bonus Rates and/or Market Level Adjustments (MLAs)

3.5.1 **Asset shares** are calculated for groups of policies with similar durations within each policy class.

3.5.2 **Terminal bonuses** are then normally declared or applied having regard to any excess, for groups of policies, of **asset shares** above the value of **guaranteed benefits** (including **annual bonuses** already added). This principle applies to all claim types, including surrenders.

3.5.3 **MLAs** are then normally applied having regard to any shortfall, for groups of policies, of 100% of **asset share** below corresponding unit

values (including **annual bonus** additions). This principle only applies to claim types under which a **MLA** may be applied (eg. surrenders)

3.5.4 **Terminal bonus** rates are influenced by the experience of the **Fund** over the policy lifetime, particularly as regards investment return, and also by the amount of guaranteed basic benefit allocated at outset. Hence the **premium rates** in force at outset may influence the terminal bonus rate at the claim date.

3.5.5 The general objective is to pay, for groups of policies, 100% of the **asset share** at maturity or on early surrender. For practical purposes some **smoothing** of **terminal bonus** rates may be applied and maturity values for groups of policies will generally be within the range 95% to 105% of **asset share and 90% to 110% on early surrender**. The exception is policies where no **terminal bonus** can be afforded due to high **guaranteed benefits**, and in these cases it may be unavoidable that more than 105% of **asset share** is paid. In these cases the excess will be borne by the **estate**, and not directly by other maturing policies.

3.5.6 The different rates of **terminal bonus** applying will be determined at the discretion of the **Firm** having regard to the characteristics of individual classes of business (e.g. guaranteed growth rates, investment mix, tax).

3.5.7 It may not always be appropriate to set **terminal bonus** rates that target 100% of **asset share** on claim. For example as the volume of in-force with profits business reduces, the degree of **smoothing** may need to change to ensure the remaining policyholders are to obtain fair values at the point of claim.

3.5.8 It may be appropriate to pay less than 100% of **asset share** on claims if, otherwise, the interests of the remaining policyholders could be unduly adversely affected. This situation could arise if, for example, a group of policyholders sought to withdraw at a time when significant upward **smoothing** was taking place.

3.5.9 It would not be appropriate to pay 100% of **asset share** on claims if this could jeopardise the solvency of the **Fund** or would be contrary to the Overriding Principle.

3.6 The Approach to Smoothing

3.6.1 No significantly different approach to **smoothing** would normally be made by type of claim.

3.6.2 The **Firm's** intention is that the cost of **smoothing** should be neutral over time. This means that, at different times, payouts to policyholders may be guided by more or less than 100% of **asset shares.**

3.6.3 There are specific costs of **smoothing** over the shorter term that the **Firm** believes should not be exceeded.

3.6.4 The calculation of **MLAs** for unitised business and surrender values for traditional (non-unitised) business is normally only made by reference to underlying asset values. However, there may be occasions where policyholder behaviour has an impact; for example, if a group of policyholders sought to withdraw at a time when significant upward **smoothing** was taking place.

3.7 Investment Strategy

3.7.1 The fixed interest portfolio is invested with the objective that, as far as is reasonable, 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 the expected future **annual bonuses**. The same applies for **non-profit liabilities** held within the **Fund**, such as annuities in payment.

3.7.2 Benefits which are not guaranteed, such as accrued **terminal bonus** are generally backed by UK equities.

3.7.3 For with profits pension policies where no **terminal bonus** can be afforded, the investments backing the **asset share** will be entirely fixed interest stocks.

3.7.4 In certain circumstances the **Firm** may rely on assets held within the **shareholder's** fund in order to maintain the investment strategy of the **Fund.**

3.7.5 It may be appropriate to utilise **derivatives** to protect the **Fund** against adverse market movements (e.g. equity falls or changes in fixed interest yields). It may also be appropriate to utilise **derivatives** for short-term asset allocation purposes or to increase diversification by gaining exposure to different asset classes or for efficient portfolio management.

3.7.6 Exposures to individual **counterparties** (including **derivative** exposures) across the entire **Fund** would not normally exceed **regulatory admissibility limits**. An appropriate spread of assets between **counterparties** will be held in order to reduce risk.

3.7.7 Management meet regularly with the investment manager to discuss all investment issues pertaining to the **Fund**.

3.7.8 The **Fund** would not usually expect to invest significant amounts in assets that would not normally be traded because of their importance to the **Firm**.

3.8 Business Risk

3.8.1 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 **Firm** at any time. Currently the volumes received of such business are very small.

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

3.9 Management and Administration Expenses

3.9.1 All normal management and administration expenses, other than investment expenses, are met by the **shareholder** through the **shareholder**-owned service company Guardian Companies Services Ltd. The **Fund** pays the **shareholder** an agreed level of expenses, which is set as the base date unit costs increased by **RPI** plus 1% each year.

3.9.2 The **Fund** pays an agreed annual management charge to the **investment manager** Kames Capital for investment management services.

3.9.3 **Policy charges** on **unitised with profits** policies are the same as for other unit-linked policies, and can be increased by the **Firm**. The difference between the charges and the actual expense and mortality experience on **unitised with profits** policies forms part of the **Bonus Surplus**.

3.10 Management of the Estate

3.10.1 The **Firm** aims 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. The distribution of the **estate** is achieved by using **Bonus Surplus** to enhance **asset share** returns.

3.10.2 The **Firm** aims to maintain a sufficient level of **estate** within the **Fund** to meet the regulatory requirements that would apply were the **Fund** a separate **Firm**.

3.10.3 The **estate** provides capital support towards meeting **regulatory solvency requirements**.

3.10.4 The **estate** is used to meet the cost of guarantees (which includes meeting the excess when more than the **asset share** is paid out), the costs for the use of capital and any **smoothing** costs.

3.10.5 The **shareholder** has no entitlement to the **estate** other than by way of 10% of the profits that emerge through the distribution of the **estate.**

3.11 Equity between the With Profits Fund and Shareholder

3.11.1 In accordance with the Memorandum and Articles of Association of the **Firm**, **shareholders** receive 10% of the profits arising in the **Fund.**

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

Guardian Assurance Ltd
4. Practices of Financial Management of With Profits Business

4.1 General

4.1.1 The **Firm** has written a variety of with profits business over many years. In particular, there is a wide range of policies with differing levels of guarantee in existence.

4.1.2 The **Firm** 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 minimised as generally the terms on which it is accepted can be varied by the **Firm** at any time. Currently the volumes received of such business are very small.

4.1.3 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).

4.1.4 The main classes of with profits business are as follows:

4.1.4.1 Pension Plus, Versatile Individual Pension Plan and Buy-Out Plan

These are annual or single premium deferred annuities with a guaranteed cash option at the normal retirement date. Increments are accepted, but the **premium rates** are not guaranteed and hence can be varied to reflect market conditions. Current interim **annual bonus** rates are 0.5%, and **terminal bonus** rates are 0% for most of the business and likely to remain so 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.

4.1.4.2 Personal Pension & Participating Pension

These are Section 226 retirement annuities with a guaranteed cash option. Policies are written to age 70 but have guaranteed early retirement terms from age 60. Increments are accepted on guaranteed terms, but only on a limited number of policies which have been previously endorsed to accept increments. 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.

4.1.4.3 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.

4.1.4.4 Chargeable Rates

This is a grouped Funding type of group pension scheme contract with a guaranteed cash option. Bonus rates are fully allowed for in the **premium rates** (but not guaranteed) on the basis of investment in fixed interest securities. The **annual bonus** rate is 2.6% and the **terminal bonus** rate is 10%.

4.1.4.5 Freedom Unitised With Profits

These are unit-linked with profits contracts. Unit values are guaranteed (i.e. the with profits unit price cannot go down), and unit prices increase daily at the current bonus interest rate, which is not guaranteed. The current bonus interest rate is 1.25%.

The guaranteed rate of return is 0% p.a. in the unit values.

4.1.4.6 Choices Unitised With Profits

These are unit-linked with profits personal pensions. 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% and the current bonus interest rate is 1.0%. The rates are not guaranteed

The guaranteed rate of return is 0% p.a. in the unit values.

4.1.4.7 Deposit Administration

Deposit Administration is a group scheme deposit-type contract. 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 guaranteed rate of return is 0% p.a.

4.1.4.8 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 contract is backed by fixed interest securities.

The guaranteed rate of return is 0% p.a.

4.1.5 The assumed investment mix of each with profits class above will differ, depending on the maturity of the business and the proportion of the final pay-out which is guaranteed.

4.1.6 The **Fund** has also written a significant amount of non-profit and unit-linked business, primarily term assurances, immediate and deferred annuities, and Freedom and Choices unit-linked (non-with profits) policies.

4.1.7 Under the terms of the **Fund** restructure in 1998 the cost of certain guarantees were retained by **Fund**. In particular, the cost of a Maturity Guarantee under a unit linked contract written by Guardian Linked Life Assurance Ltd.

4.2 The Amount Payable under a With Profits Policy

4.2.1 The amounts payable under Deposit Administration and Pension Saver policies are predominantly based on 15 year gilt yields as described above in 4.1.4. The amounts payable under Chargeable Rates policies are based on the **premium rates** and fixed interest yields as described in 4.1.4.4 above.

4.2.2 The amounts payable under other with profits policies are guided by the calculation of **asset shares**, which would normally be calculated on a monthly basis but no less frequently than annually.

4.2.3 For **unitised with profits** (Freedom and Choices) policies, **asset shares** reflect the accumulation of premiums applied less policy charges, less contributions towards the expected cost of guarantees where appropriate, less investment expenses, less costs for the use of capital where appropriate, less the shareholder's share of the cost of bonus, less any partial withdrawals made by the policyholder, at the rate of investment return on the underlying assets notionally backing the relevant policies, adjusted for tax where appropriate and increased for **Bonus Surplus** where appropriate.

4.2.4 For traditional (non unitised) with profits policies (Pension Plus, Versatile Individual Pension Plan, Buy-Out Plan, Personal Pension,

Participating Pension and Life Assurance), **asset shares** reflect the accumulation of premiums applied less expenses including commission, less contributions towards the expected costs of guarantees where appropriate, less costs for the use of capital where appropriate, less the shareholder's share of the cost of bonus, less an allowance for mortality experience at the rate of investment return on the underlying assets notionally backing the relevant policies, adjusted for tax where appropriate and increased for **Bonus Surplus** where appropriate.

4.2.5 The key parameters underlying the calculation of **asset shares** are as follows:-

4.2.5.1 Investment Returns

Prior to 1st January 2010, assumed investment returns in the **asset share** model were normally based on published indices for equities and fixed interest securities. Since 1st January 2010, the actual investment returns achieved by the **Fund's** investment managers have been used. Actual investment performance is reported on a monthly basis by the **Fund's** investment managers. Actual returns on property investments held in the **Fund** up to 2000 are also used.

4.2.5.2 Asset Allocation

The investments notionally backing with profits business vary by class of business and by duration in force. It is assumed that a proportion of each future premium and the accrued **asset share** is invested in fixed interest assets. The proportion and duration of the modelled fixed interest investment is such that the projected cash flows from the fixed interest investments match the guaranteed with profits liabilities, such as **basic sums assured**, accrued **annual bonuses**, as well as the expected future **annual bonuses**. Any proportion of the **asset share** or premium not needed to match the projected guaranteed payments is assumed to be invested in equities. This is consistent with the investment strategy of the **Fund**.

4.2.5.3 Taxation

Investment returns are adjusted for taxation where appropriate, based on estimates of the rate of taxation actually paid by the **Firm** over the appropriate period.

4.2.5.4 Expenses traditional (non-unitised) with-profit policies

Since 1st January 2000, expenses other than investment expenses are met by the **shareholder** through the **shareholder**–owned servicing company Guardian Companies Services Ltd (formerly AEGON UK Services Ltd). The **Fund** pays the **Firm** an agreed

level of expenses, which is set as the base date unit costs increased by **RPI** plus 1% each year.

The per policy expenses, since 1st January 2000, assumed in the **asset share** model are based on the agreed level of expenses. Prior to 1st January 2000, policy expenses assumed within the model are based on the results of annual expense investigations, which allocate expenses to each class of business. Actual past rates of commission are used.

Since 1st January 2010, the model has made direct allowance for the investment expenses incurred.

4.2.5.5 Annual Management Charges (Unitised Policies)

This charge is consistent with that taken from other unit-linked funds within the **Fund**. The charge can be varied.

4.2.5.6 Mortality

An approximate allowance is made for mortality experience.

4.2.5.7 Cost of Guarantees 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.

4.2.6 The determination of amounts payable to with profits policyholders in respect of **guaranteed or contractual benefits** or by way of bonus declarations (which are the absolute discretion of the **Board** having regard to the surplus available for distribution and in accordance with the Overriding Principle) have regard to methods of assessment approved by the **Board**. Records of the parameters and assumptions used are retained within the Finance Actuarial function of the **Firm**.

4.2.7 Any change to the methods used to assist in the determination of the amounts payable to with profits policyholders requires the approval of the **Board** (in accordance with the Overriding Principle), as do changes to the current parameters or assumptions (apart from the routine incorporation of new investment returns).

4.3 The Approach to setting Annual Bonus Rates

4.3.1 The general approach to setting **annual bonus** rates is to project current **asset shares** to maturity, assuming estimates of future investment returns. These projections can be used to ascertain if **annual bonus** rates are supportable in the future.

4.3.2 Different rates of annual bonus apply depending on the characteristics of the individual classes of business written by the **Firm** (e.g. guaranteed growth rates, investment mix, tax). The **annual bonus** rates do not currently vary between single premium and annual premium business.

4.3.3 For other than Deposit Administration, Pension Saver and Group Funding, rates were reduced at the 31st December 2004 declaration to such a level that no further reductions are planned. Interim bonus rates are currently at the levels quoted in 4.1 above, and the **Firm** anticipates that **annual bonuses** can be maintained at this level in the future if investment returns are not significantly less than anticipated and mortality experience, particularly annuitant mortality, does not change significantly from that anticipated. The investment strategy is consistent with the intention of not reducing **annual bonus rates** further as outlined in 4.6 below.

4.3.4 If future investment returns are significantly better than expected then **terminal bonus** rates will be increased above those that would otherwise have applied. **Annual bonus** rates will be reduced if future investment returns are significantly worse than expected or as required by the Overriding Principles.

4.3.5 Deposit Administration and Pension Saver annual bonus rates are set by reference to 15 year gilt yields as outlined in 4.1 above. Group Funding bonus rates are set by reference to the **premium rates** and fixed interest yields as outlined in 4.1 above.

4.3.6 The same rate of **annual bonus** applies to all policies within a class irrespective of when the policies were taken out. Differences between generations are dealt with, where possible, through the **terminal bonus** structure and/or **MLA**. This could change if the **asset shares** of particular **cohorts of policyholders** were low relative to their **guaranteed benefits**. In such a circumstance, it could be appropriate for lower **annual bonus** rates to apply to that **cohort**.

4.3.7 The current practice for traditional non-unitised with profits contracts is to declare **annual bonus rates** in arrears, normally once a year on 31 December. Interim **annual bonus rates** are normally declared twice a year on 1 April and 31 December respectively. The 1 April declaration applies to appropriate claims in the period 1 April to 31 December and the 31 December declaration to appropriate claims in the period 1 January to 31 March.

4.3.8 The current practice for **unitised with profits contracts** is to declare the **annual bonus rates** in advance, normally once a year on 1 April. The unit prices then change each day on a basis consistent with the pre-declared rates of **annual bonus**.

4.3.9 There are no restrictions on the amount **annual bonus rates** can change from one year to the next.

4.4 The Approach to setting Terminal Bonus Rates, Market Level Adjustments and Surrender Values

4.4.1 **Terminal bonus** rates vary by type of policy and by the year a policy (or benefits within a policy) started to participate in the profits of the **Fund**.

4.4.2 The **Firm** expects to review **terminal bonus** rates monthly. In times of significant market volatility, these reviews could become more frequent. Conversely, in times of stable markets, these reviews could become less frequent. **Terminal bonus** rates can be changed at any time.

4.4.3 Life Assurance

4.4.3.1 **Asset shares** for groups of policies with similar durations maturing in a particular year are calculated and then compared with the **guaranteed benefits. Terminal bonuses** are then normally declared or applied having regard to any excess of **asset shares** above the value of **guaranteed benefits** (including **annual bonuses** already added) for groups of policies. The **terminal bonus** rates are rounded to produce a **smooth** scale (such rounding aims to be cost-neutral over time). The resulting maturity payouts for groups of policies will generally be on average equal to 100% of the **asset share.** This average will fluctuate during the year within the range 95% to 105% of the **asset share** in accordance with the **smoothing** outlined in 4.5.

4.4.3.2 On early surrender or transfer, formulaic calculations are applied to both the guaranteed maturity benefits (including accrued **annual bonus** additions) and any **terminal bonus** likely to be available at the rates then current, in order to derive a surrender or transfer value. These calculations require assumptions to be made about future investment returns, **annual bonuses** and mortality rates and, will therefore change from time to time. The objective is to pay on average 100% of **asset share** on early surrender for groups of policies.**.** This average will fluctuate during the year within the range 90% to 110% of the **asset share** in accordance with the **smoothing** outlined in 4.5.

4.4.3.3 Whilst on average the intention is to pay 100% of **asset share** on maturity and surrender (subject to the operation of the **smoothing** practice set out in 4.5 below), individual policy payouts are likely to be in a range of 70% to 130% of **asset share**. This relatively wide variation is mainly caused by the non-proportionate variation in **asset shares** between similar policies with different levels of premium. The majority of policy payouts are much closer to **asset share** than might be implied by this relative wide range.

4.4.3.4 **Asset shares** are not calculated for whole of life policies, paid-up policies, altered policies or other minor classes of business. Consistent with past practice **terminal bonus** rates for these groups of policies are set equivalent to the relevant endowment rate based on the year the policies started to participate in the profits of the **Fund**. Similarly, surrender values for these policies are calculated using similar calculations as per the equivalent endowment policies.

4.4.4 <u>Pension Plus, Versatile Individual Pension Plan, Buy Out Plan, Personal Pension, Participating Pension</u>

4.4.4.1 The approach to setting **terminal bonus** rates is similar to that for life assurance business except the benefits available at the normal retirement date are expressed in the form of a guaranteed level of annuity. **Terminal bonuses** are declared or applied having regard to any excess of **asset shares** above the value of **guaranteed benefits** (including **annual bonuses** already added). However, for the majority of the business, the **guaranteed benefits** at retirement exceed the **asset share** and hence the **terminal bonus** rate is zero and the pay-out may exceed 105% of **asset share**. Also, for Pension Plus business, the **terminal bonus** rates can be higher for younger policies than for older policies. This is because the **premium rates** have been changed several times in the past for these policies, and the **premium rates** for policies more recently taken out provided a lower level of guaranteed benefit and hence more scope for terminal bonus.

4.4.4.2 On early surrender or transfer an annuity is calculated consistent with the guaranteed annuity available at the normal retirement date, but reduced to reflect the fact that benefits are being taken early. The reduction is consistent with the implied guaranteed rate of return based on the premiums paid. If allowable based on the age of the policyholder an annuity of at least this amount will be paid. If an annuity cannot be offered because the policyholder is too young then a transfer value is offered based on the then current value of the reduced annuity. For groups of policies, the value of the reduced annuities are compared to the corresponding **asset shares** and, if appropriate, the value of the benefits available are increased to be equivalent, on average, to 100% of the **asset share**.

4.4.4.3 If at normal retirement, policyholder chooses to convert part of the annuity into cash (eg to take a tax free cash sum or an open market cash option) then the annuity is converted into cash using the guaranteed cash option - usually 9 or 10. Hence, generally at current interest rates, the cash alternative is worth less than the guaranteed annuity. For early retirements, the annuity is also converted into cash using an age related cash option factor. The age related cash option factor is determined by interpolation from

a market annuity factor at age 50 to the guaranteed cash option at the normal retirement age. In setting terminal bonus rates and early retirement terms allowance is made for the proportion of policyholders who are expected to take their benefits in the form of annuity.

4.4.4.4 Whilst the intention is to provide benefits which on average are equal to 100% of **asset share** (subject to the **smoothing** described in 5.4) the value of the **guaranteed benefits** is such that the benefits at normal retirement and earlier are generally in excess of **asset share**. For those groups of policies, where the cost of the **guaranteed benefits** is less than **asset share**, the benefits offered at normal retirement, and earlier, are enhanced so that on average the benefits available are equivalent to 100% of **asset share** (subject to the **smoothing** described in 5.4). Hence, the individual policy benefits offered are unlikely to be less than 70% of **asset share** and, given the valuable **guaranteed benefits**, may be substantially in excess of 100% of **asset share**.

4.4.4.5 **Asset shares** are not calculated for paid-up policies, altered policies or other minor classes of business. Consistent with past practice **terminal bonus** rates for these groups of policies are set equal to the equivalent relevant deferred annuity contract based on the year the policies started to participate in the profits of the **Fund**. Similarly, transfer values and early retirement terms for these policies are calculated using similar calculations as per the equivalent relevant deferred annuity contract.

4.4.5 Unitised With Profits (Freedom & Choices)

4.4.5.1 Terminal Bonus

Asset shares for groups of policies with similar duration maturing in a particular year are calculated. For the groups of policies, **terminal bonus** rates are then calculated so that on average the claim value is equal to 100% of the **asset share.** This average will fluctuate during the year within the range 95% to 105% of the **asset share** in accordance with the **smoothing** outlined in 4.5. **Terminal bonus** rates are declared for each past year, and then each rate is applied to the average unit holding for each past year.

4.4.5.2 Final Bonus

When the **Fund** was closed to new business at the end of 1998, a new type of **terminal bonus** was introduced, called '**final bonus'**. This bonus is necessary to ensure that the **unitised with profits** policyholders who were in the **Fund** before it closed to new business receive their fair share of any part of the **estate** that is distributed.

4.4.5.3 The **Firm** aims 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 Principle. For **traditional with profits** policies, this is achieved by increasing the **terminal bonus** rates. However, policyholders with unit linked policies can switch into the **unitised with profits** fund from other linked funds**.** Hence increasing all **terminal bonus** rates would benefit policyholders who were not invested in the with profits fund when it became closed to new business. Increasing **terminal bonus** rates only for 1998 and earlier unit holdings would resolve this problem, but then annual premium policies which were only taken out shortly before the **Fund** closure would receive little benefit from the distribution of the **estate**. The solution was to increase the **terminal bonus** rate for 1998 units but also to introduce a new **final bonus**.

4.4.5.4 **Final bonus** rates are declared for each year from 1999 and the **final bonus** is calculated broadly as the annual premium paid in each year since 1999 multiplied by the **final bonus** rate for that year. For this purpose however, the annual premium is limited to a maximum of the annual premium that was being paid into the with profit units on the day it was announced that the **Fund** was restructuring.

4.4.5.5 Market Level Adjustments

A **market level adjustment** may be applied on early surrender (more than 5 years from NRD for Choices pensions) to the unit value.

4.4.5.6 When a partial withdrawal is made that exceeds the corresponding **asset share** on account of **MLA** not applying, the excess paid does not reduce the **asset share** associated with the remainder of the policy.

4.4.5.7 Target Payout Ranges

Whilst on average the intention is to pay 100% of **asset share** on maturity and surrender (subject to the operation of the **smoothing** practice set out in 4.5 below), individual policy payouts are likely to be in a range of 70% to 130% of **asset share**. The majority of policy payouts are much closer to **asset share** than might be implied by this relative wide range.

Asset shares are not calculated for relatively small number of unitised with profits policies (eg certain altered policies). Consistent with past practice **terminal bonus** rates for these groups of policies are set equivalent to the appropriate **terminal bonus** rates for the equivalent unitised with profits contracts.

Similarly, surrender values for these policies are calculated using similar calculations as per other relevant unitised with profits policies.

4.4.6 Deposit Admin and Pension Saver.

As described above, the benefits payable on Deposit Administration and Pension Saver contracts are set by reference to gilt yields. No terminal bonus is payable and **asset shares** are not calculated.

On surrender the amount payable is equivalent to the discounted value of the future benefits payable. Allowance is made for any expected reduction in basic and bonus interest rates.

4.4.7 Chargeable Rates

The bonus rates on Chargeable Rates contracts are consistent with those allowed for in the **premium rates** (but not guaranteed) on the basis of investment in fixed interest securities. **Asset shares** are not calculated for this class of business.

On surrender the amount payable is equivalent to the discounted value of the future benefits payable. Allowance is made for both future annual bonus and projected terminal bonus.

4.4.8 There are no restrictions on the degree to which payouts may change on similar policies from one bonus declaration to the next.

4.5 The Approach to Smoothing

4.5.1 **Terminal bonus** rates are reviewed annually and set at a level so that, on average, for groups of similar policies maturing in a particular year, broadly 100% of **asset share** is paid at maturity. Under current practice this review is undertaken each April. There are no restrictions on the degree to which payouts may change on similar policies from one bonus declaration to the next.

4.5.2 Rates are then normally reviewed monthly during the year, but normally only changed if the average maturity values for groups of maturing policies in a particular year are less than 95% of the **asset share** or more than 105% of the asset share. Whilst on average maturity payouts will be in the range 95% to 105% of **asset share** individual policy payouts are likely to be in a range of 70% to 130% of **asset share**. The majority of policy payouts are much closer to **asset share** than might be implied by this relative wide range.

4.5.3 Hence average maturity claim values may change by less than 5% when new **terminal bonus** rates are declared each April, but may change at any time by more than 5% if the comparison with **asset shares** requires a change in **terminal bonus** rates.

4.5.4 A similar approach to **smoothing** is adopted for surrender values. Surrender values are reviewed annually and set at a level so that, on average, for groups of similar policies the surrender values offered are broadly equal to 100% of **asset share**. Under current practice this review is undertaken in the fourth quarter of the year. There are no restrictions on the degree to which surrender values may change on similar policies when a revised surrender value basis is introduced.

4.5.5 Surrender value bases are then reviewed quarterly during the year, but normally only changed if the average surrender values for groups of policies are less than 90% of the **asset share** or more than 110% of the **asset share**. Whilst on average surrender payouts will be in the range 90% to 110% of **asset share** individual policy payouts are likely to be in a range of 70% to 130% of **asset share**. The majority of policy payouts are much closer to **asset share** than might be implied by this relative wide range. Where appropriate surrender values include an allowance for terminal bonus and if terminal bonus rates change then the surrender values will also change. This helps to ensure that surrender values reflect changes in **asset shares**.

4.5.6 The **Firm's** intention is that the cost of **smoothing** should be neutral over time. The cost of **smoothing** over any one year is met by the **estate.** The maximum cost of **smoothing** that may be borne by the **Fund** is effectively 5% of one year's claims.

4.5.7 If the **smoothing** mechanism and/or the approach to setting **terminal bonuses** described above were to jeopardise the solvency position of the **Firm**, payouts could then be allowed to fall below 100% of **asset shares.** Payouts could also rise above 100% of **asset shares** in order to avoid a **tontine effect** as the **Fund** runs down.

4.6 Investment Strategy for With Profits Business

4.6.1 At the date of this document, the assets of the **Fund** are mainly invested in UK equities and UK Government and corporate bonds. This may change in line with the Investment Principles set out earlier.

4.6.2 The fixed interest portfolio is invested with the objective that, as far as is reasonable, 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 **non-profit liabilities** held 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.

4.6.3 Benefits which are not guaranteed, such as accrued **terminal bonus,** are generally backed by UK equities. The **estate** is invested in UK fixed interest securities and UK equities.

4.6.4 For with profits pension policies where no **terminal bonus** can be afforded, the investments backing the **asset share** will be entirely fixed interest securities.

4.6.5 In certain circumstances the **Firm** may rely on **shareholders'** funds in order to maintain the investment strategy of the **Fund**.

4.6.6 The **Firm's** general policy is to hold an appropriate spread of assets between **counterparties** in order to reduce risk. Additionally, the **Firm** would normally expect at least 95% of its fixed interest securities to have credit ratings of BBB or higher. At times of significant downgrades the proportion of fixed interest securities below BBB could be greater than 5%. The **Firm** would not normally expect to become a forced seller of fixed interest securities should credit ratings on investments held fall from BBB or higher to below BBB.

4.6.7 The **Firm** would not normally invest in assets of sufficient concentration that would cause **regulatory admissibility limits** to be breached.

4.6.8 Any substantial investment in new or novel investment instruments would require the approval of the Board.

4.6.9 The **Fund** would not usually expect to invest significant amounts in assets that would not normally be traded because of their importance to the **Firm**.

4.6.10 The **equity backing ratio** within each class of business may vary from policy to policy depending on when the policy was taken out and how long is left to maturity/retirement. Rates currently applicable are:

> Life Assurance business is generally in the range 25% to 55%.
>
> **Unitised with profit** pension business is generally in the range 30% to 65% and **unitised with profit** life business in the range 15% to 55%.
>
> Pension Plus, Versatile Individual Pension Plan and Buy-out Plan is generally in the range of 0% to 20%.
>
> Personal Pension and Participating Pension is generally in the range of 0% and 30%.
>
> Chargeable Rates, Deposit Administration and Pension saver are matched entirely by fixed interest securities.

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

4.6.11 The **Firm** does not currently invest in overseas equities.

4.6.12 It may be appropriate to utilise **derivatives** to protect the **Fund** against adverse market movements (e.g. equity falls or changes in fixed interest yields). It may also be appropriate to utilise **derivatives** for short-term asset allocation purposes or to increase diversification by gaining exposure to different asset classes or for efficient portfolio management.

4.6.13 The control environment for the use of **derivative** instruments involves: approval by a senior investment manager that the initial investment is within permitted parameters; segregation of duty between those who authorise deals and those who trade deals; and monthly discussion of **derivative** reports.

4.6.14 Management meet regularly with the investment manager to discuss all investment issues pertaining to the **Fund**.

4.6.15 Formal reviews of the investment strategy of the **Fund** would normally be made annually.

4.7 Business Risk

4.7.1 The **Firm** 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 **Firm** at any time. Currently the volumes received of such business are very small.

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

4.8 Management and Administration Expense

4.8.1 All normal management and administration expenses, other than investment expenses, are met by the **shareholder** through the **shareholder**-owned service company Guardian Companies Services Ltd, and the **Fund** pays the **shareholder** an agreed level of expenses, which is set as the base date unit costs increased by **RPI** plus 1% each year.

4.8.2 The **Fund** pays an agreed annual management charge to the **investment manager** for investment management services. Since 1st January 2010, the terms of the investment charge have been amended to vary by asset class and also include a performance fee if investment performance exceeds an agreed benchmark. .

4.8.3 **Policy charges** on **unitised with profits** policies are the same as for other unit-linked policies, and can be increased by the **Firm.** The difference between the charges and the actual expense and mortality experience on **unitised with profits** policies forms part of the **Bonus Surplus.**

4.9 Management of Estate

4.9.1 The **Firm** aims 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 Principle. The distribution of the **estate** is achieved by using **Bonus Surplus** to enhance **asset share** returns.

4.9.2 The **Firm** aims to maintain a sufficient level of **estate** within the **Fund** to meet the regulatory requirements that would apply were the **Fund** a separate **Firm**.

4.9.3 The **estate** provides capital support towards meeting **regulatory solvency requirements**. It is intended that the **estate** be maintained at

such a level that no capital support should be required from the **shareholder.**

4.9.4 The **estate** is used to meet the cost of guarantees (which includes meeting the excess when more than the **asset share** is paid out), the costs for the use of capital and any **smoothing** costs.

4.9.5 The **shareholder** has no entitlement to the **estate** other than by way of 10% of the profits that emerge through the distribution of the **estate.**

4.9.6 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 now met by the **estate** whereas prior to 30th June 2005 it was charged directly to **asset shares**.

4.9.7 Currently any compensation or redress in connection with the way business written in the **Fund** has been marketed or sold is met by the **estate.**

4.10 Equity between the With-Profit Fund and the Shareholder

4.10.1 In accordance with the Memorandum and Articles of Association of the **Firm**, **shareholders** receive 10% of the profits arising in the **Fund**

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

GUARDIAN ASSURANCE Ltd

5. GLOSSARY OF TERMS WITHIN PRINCIPLES & PRACTICES OF FINANCIAL MANAGEMENT OF WITH PROFITS BUSINESS

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:	Used as a guide to setting bonus rates – see 4.2.
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.
Cohorts of Policyholders:	Groups of policyholders with similar characteristics (e.g. same month of policy commencement or premium payment).
Counterparty:	An organisation or individual with which the Firm has made investments or against whom it has rights whether in pursuance of a contract entered into by the insurer or otherwise.

Derivatives:	Financial instruments that are either contracts for differences, futures or options.
Equity Backing Ratio (EBR):	The proportion of assets invested in equities.
Estate:	The excess, on a realistic basis, of assets within the Fund over and above the amount required to meet liabilities.
Final Bonuses:	Non-guaranteed amounts that may be added to guaranteed benefits (including annual bonus additions) when a claim arises.
Firm:	Guardian Assurance Ltd
Fund:	The Firm's long-term insurance fund into which with profits and non-profit business is written.
Guaranteed Benefits:	Amounts guaranteed 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.
Guaranteed Annuity Options:	An option, which exists under certain group scheme pension contracts, to convert the fund available at retirement to an annuity on guaranteed terms as set out in the Policy Conditions.
Investment Manager:	Kames Capital
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 liabilities:	Policies which do not share in the distribution of profits of the Fund, such as unit linked policies.

Orphan Estate:	A part of the estate that has been identified as not belonging to the current with profits policyholders.
Policy Charges:	Charges as defined in the Policy Conditions (e.g. an annual management charge). Market Level Adjustments are not included in this definition.
Premium rate:	The rate which determined how much initial guaranteed benefit was given at the outset of the policy for a given premium.
Regulatory Admissibility Limits:	Limits specified by the Financial Services Authority relating to the maximum amounts of specific asset types (and counterparty exposures) that can be counted towards solvency purposes.
Regulatory Solvency Requirements:	The minimum excess of assets over liabilities that must be maintained in accordance with the requirements of the Financial Services Authority.
RPI:	Retail Price Index (a measure of inflation)
Shareholder:	Cinven
Smoothing:	The operation of smoothing fluctuations in investment returns and asset shares over time, when setting terminal bonus rates.
Terminal Bonuses:	Non-guaranteed amounts that may be added to guaranteed benefits (including annual bonus additions) when a claim arises.
Tontine Effect:	The effect associated with a declining fund, where the last remaining policyholder is entitled to the remaining surplus in the fund.

Traditional With Profits:	A with profits policy that, in accordance with the Policy Conditions, offers a level of guaranteed benefit in return for the payment of a premium or an agreed series of premiums. Offers no facility to switch into a unit-linked contract.
Unitised With Profits:	A with profits policy that, in accordance with the Policy Conditions, offers a level of guaranteed benefit linked to the payment of each individual premium. Guaranteed benefits (including annual bonus additions) are expressed in terms of a unit value. Offers the facility to switch into a unit-linked contract.
With Profits Actuary:	An actuary appointed under Chapter 4 of the Supervision Manual of the Financial Services Authority.