



Zurich International Life Limited

Principles and Practices of Financial
Management of the Guaranteed
Accumulation Funds

Table of Contents

1.	INTRODUCTION.....	1
2.	OVERVIEW	2
2.1	Structure of Zurich International Life Limited and its Funds.....	2
	2.1.1 The Company.....	2
	2.1.2 Fund structure	2
2.2	Sharing of surplus.....	3
2.3	Operation of the GAF funds	3
	2.3.1 Types of GAF funds	3
	2.3.2 Dividends.....	4
	2.3.3 Market Level Adjustments	4
	2.3.4 Smoothing.....	5
	2.3.5 Investments	5
	2.3.6 'The Estate'	6
2.4	GAF Governance	6
3.	GUIDING PRINCIPLES	7
3.1	Introduction	7
3.2	Guiding Principles.....	7
3.3	Practice.....	9
	3.3.1 Types of charges.....	9
	3.3.2 Reviews of the charging basis	9
4.	MANAGEMENT OF THE ESTATE	10
4.1	Principles.....	10

4.2	Practice	10
4.2.1	The Estate	10
4.2.2	Management of the Estate	11
4.2.3	Management of the GAF funds in the future	11
4.2.4	Investment strategy for the Estate	12
4.2.5	Shareholder support.....	12
5.	AMOUNTS PAYABLE ON CLAIMS	13
5.1	Principles	13
5.2	Practice	13
5.2.1	Determination of payouts on maturity	13
5.2.2	Factors influencing surrender values.....	13
5.2.3	Amounts payable on death claims.....	14
5.2.4	Documentation of methodology and assumptions	14
6.	DIVIDEND POLICY	15
6.1	Principles	15
6.2	Practice	15
6.2.1	General approach to determining dividend rates.....	15
6.2.2	Frequency of review of dividend rates.....	16
6.2.3	Changes in dividend rates from year to year	16
6.2.4	Changes in dividend rate scales.....	16
7.	SMOOTHING	17
7.1	Principles	17
7.2	Practices	17
7.2.1	Smoothing.....	17

7.2.2	Types of smoothing	17
7.2.2.1	Smoothing within groups of policies	18
7.2.2.2	Smoothing across groups of policies	18
7.2.2.3	Smoothing of interim and annual dividend rates	18
7.2.3	Current smoothing criteria	18
7.2.4	Limits on smoothing	19
8.	INVESTMENT STRATEGY	20
8.1	Principles.....	20
8.2	Practice.....	20
8.2.1	Investment objectives.....	20
8.2.2	Review of investment strategy	21
8.2.3	Matching of assets and liabilities.....	21
8.2.4	Investment in different asset classes	22
8.2.5	Use of new types of investments	22
8.2.6	Non-tradable assets.....	22
8.2.7	Use of Derivatives.....	22
9.	EXPOSURE TO BUSINESS RISK.....	23
9.1	Principles.....	23
9.2	Practice.....	23
9.2.1	Risk Management Committee.....	23
9.2.2	Major risks	23
9.2.2.1	Guarantees associated with with-profits policies.....	23
9.2.2.2	Investment risks	24
9.2.2.3	Miscellaneous business risks affecting the with-profits business.....	24

9.2.2.4 Potential compensation claims in respect of allegations of misselling	24
9.2.3 Impact of risks on payouts	25
9.2.4 Impact of external risks	25
10. AMENDMENTS TO THE PPFM.....	26
10.1 Amendment to the Principles.....	26
10.2 Amendment to the Practices	26
APPENDIX A – GLOSSARY	28

1. INTRODUCTION

The Conduct of Business sourcebook of the Financial Services Authority ('FSA') requires firms to establish and maintain the Principles and Practices of Financial Management ('PPFM') according to which the business of each of its with-profits funds is conducted.

This document sets out the PPFM that Zurich International Life Limited ('ZILL' or 'the Company') applies in managing its Guaranteed Accumulation funds ('GAF'). It plays an important role in the governance of GAF funds and ensuring that customers are treated fairly. For a description of what is meant by 'fairness' in this context, please refer to the Guiding Principles set out in Section 3.

Principles are statements which reflect the general approach adopted in managing the with-profits business and they are not expected to change often. If the Directors decide that a Principle should be changed, the procedures that will be followed are set out in Section 10.1.

Practices are statements of specific practice employed in managing the with-profits business. They reflect ZILL's current approach given the prevailing regulatory, business and economic environment affecting the with-profits business. Practices are likely to be revised in response to changes in this environment, as well as to the development of new methods and techniques in the life insurance industry. Where circumstances change gradually, then changes in practice are expected to be gradual. However, it is possible that practices could change more rapidly or to a greater extent in response to abrupt changes in circumstances. The procedures for changing practices are set out in Section 10.2.

Section 2 gives a brief overview of the structure of ZILL and its GAF funds. Section 3 states the overarching principles for management of the GAF funds. The remaining sections cover specific issues relating to the management of the GAF funds.

2. OVERVIEW

This section aims to give a high level introduction to the structure of ZILL and the operation of the GAF funds. It does not provide a comprehensive summary of the business, and readers should refer to later sections of this PPFM document where the different aspects of the business are covered in more detail.

2.1 Structure of Zurich International Life Limited and its Funds

2.1.1 *The Company*

ZILL is a wholly owned subsidiary of Zurich Assurance Limited (ZAL) which is itself a wholly owned subsidiary of Zurich Financial Services (UKISA) Limited ('ZFS'). Zurich Assurance Limited began operating in 1991 when the life and non-life insurance businesses of Eagle Star were separated and the existing life insurance business was transferred into the new company.

ZILL has been operating since 1982 and is a separate subsidiary managed and incorporated in the Isle of Man.

2.1.2 *Fund structure*

ZILL consists of a Long Term Business fund ('LTBF') and a Shareholder fund ('SH Fund'). Within the LTBF there are a number of unit-linked funds as well as the GAF funds. Long Term Business Fund (LTBF) is The sub-fund of the Company that holds the assets available to meet the liabilities under the Company's long-term life and pensions policies. Shareholder fund ('SH Fund') is the sub-fund of the Company that is separate to the Long Term Business fund and in which policyholders have no interest.

The SH fund contains assets which belong entirely to shareholders. Policyholders have no direct interest in the assets of this fund.

Separate assets are allocated to each of the LTBF unit-linked funds and the GAF funds and each fund has its own investment strategy or strategies. The asset mix for different insurance policies in each fund may well vary to reflect different features, such as the type of assets to which the fund is linked, the outstanding period to when benefits become available and the type and extent of any guarantees.

Although under insurance company law all the assets of the LTBF are theoretically available to meet the liabilities in the fund, ZILL manages the funds such that under normal circumstances only the assets of a given sub-fund are available to meet the liabilities of that fund. In very adverse circumstances, financial support for the LTBF may be provided from the SH fund. Financial support in this context means a transfer or notional allocation of assets other than would occur in the normal operation of the business, and such support may be either temporary or permanent in nature depending on the circumstances at the time. However, other than in extreme circumstances the unit-linked funds will not provide any financial support for the GAF funds (and vice versa). The GAF fund will not be used to provide financial support to the SH fund under any circumstances.

2.2 **Sharing of surplus**

Although the GAF funds are classified as with-profits business solely for the purposes of the FSA regulations, the GAF funds, unlike some with-profits policies, do not give any right to share in the profits of the company generally. However, a surplus arising within the GAF fund in the form of Distributable Investment Earnings is shared between with-profits policyholders and shareholders in the proportions 90% to policyholders and 10% to shareholders. The Distributable Investment Earnings are the income and gains, net of investment losses, which the Company's Actuary calculates as arising in a GAF fund in a calendar year. Surplus is distributed to GAF policyholders in the form of dividends. Please note that GAF funds do not present the same risks to clients as UK with profits funds.

2.3 **Operation of the GAF funds**

2.3.1 **Types of GAF funds**

The GAF funds are designed to offer smoothed, relatively stable growth and a guaranteed medium-term return, backed by investments in high quality corporate and government bonds. This combination makes these funds ideal for consolidation of equity gains and for protecting a portfolio's value as it nears maturity. The GAFs are available in sterling, US dollars and euros and offer capital growth through investments in the global bond market. The funds protect against loss by 'smoothing' the dividends and offering medium-term guaranteed returns.

2.3.2 Dividends

In March each year, ZILL will announce an interim dividend for each of the GAF funds, based on an estimation of the expected returns. During the year, this interim dividend will be credited to the investor's account on a monthly basis. Once added, the dividend cannot be reduced or taken away as long as the policy is maintained to maturity, or a permitted withdrawal point (variable by product).

At the end of the year, when the actual return from the fund has been calculated, an annual dividend is announced for each of the GAF funds. When this annual dividend exceeds the interim dividend already credited, a 'bonus dividend' is added to each investor's account to make up the difference. If the annual dividend is less than the interim dividend, the interim dividend already received cannot be reduced.

The levels of dividends payable on policies in the GAF funds are determined by the Company, and depend on the profits arising in the Fund over time. It is possible that if profits are insufficient then dividends in one or more years could be zero.

ZILL's approach to dividends is described in more detail in Section 6.

2.3.3 Market Level Adjustments

In some circumstances, an adjustment may be applied on claims on policies investing in the GAF funds which reduces the claim value to below the purchase or face value of the attaching GAF funds. Such an adjustment is known as a Market Level Adjustment (MLA). The Company applies MLAs in order to protect the interests of continuing policyholders in the Fund.

In order to protect existing investors against the dilution of their return, an MLA may be applied when an investor withdraws from the GAF before a permitted withdrawal point (variable by product). The MLA means that there may be a reduction in the amount paid out. The MLA is administered on a case-by-case basis, and its amount depends on when the investor's funds were invested, how long they were invested, and the market conditions over this period.

The Company will normally consider applying an MLA when the market value of the assets backing the GAF fund policies is below the nominal unit value, and in particular where there is a high volume of surrenders of policies linked to the GAF funds. The rate of any MLA

applying from time to time can be varied frequently by the Company. The rate of MLA may be different for different policy types and may vary according to the period over which the policy has been invested in the GAF fund.

On some policy types, the Company guarantees that no MLA will be applied in certain circumstances or on certain dates called permitted withdrawal points, such as on a given policy anniversary, on death, at maturity or (for certain policy types) in relation to regular partial withdrawals up to a certain amount. In this document, we have used the term 'Permitted withdrawal point' to refer to any date or event on which an MLA will not be applied. The amount paid out on a claim on a policy link to the GAF fund on a permitted withdrawal point will not be less than the nominal value of any GAF units cancelled to meet the cost of the claim.

2.3.4 *Smoothing*

ZILL regards smoothing as a normal part of the operation of the GAF funds. Essentially, the purpose of the smoothing process is to reduce the impact on claim payments of fluctuations in asset values and other factors affecting the business. ZILL applies smoothing by means of the dividend mechanism.

ZILL is able to smooth the returns from the GAF funds, ensuring that the year-on-year return does not fluctuate wildly despite the performance of the underlying assets. In years in which the assets perform well, the fund may not distribute all returns, effectively creating a reserve from which the fund's dividend can be 'topped-up' in lean years.

The degree to which ZILL can reasonably apply smoothing depends on the available financial resources of the GAF fund, and in adverse circumstances the Company may substantially reduce or cease to apply smoothing.

ZILL's approach to smoothing is described in more detail in Section 7.

2.3.5 *Investments*

ZILL uses a mix of investments to support the GAF funds. The fund does not invest in equity-type assets (such as UK and overseas shares, as well as property) and the main assets are fixed interest type assets (such as government bonds and high quality corporate bonds). It may change the mix of assets or use different assets in accordance with its overall investment

strategy in operation from time to time. Generally, the overall investment strategy is set with the aim of ensuring that the GAF funds can continue to provide guaranteed returns over the medium term using a suitable portfolio of assets with an acceptable level of risk. Within this framework the Company expects, to allocate notionally different mixes of assets to different groups of policies to take account of factors such as the outstanding term to maturity or the next permitted withdrawal point, and the level and type of any underlying guarantees.

2.3.6 'The Estate'

The Estate is a technical term which describes the difference between the total assets in the GAF Funds and those needed to support the current and future liabilities of the Fund. In effect, the Estate is the means by which ZILL is able to provide a degree of smoothing on the business in the GAF fund. ZILL aims to distribute 90% of the Estate over the remaining lifetime of the GAF business in force using the dividend mechanism.

The management of the Estate is described in more detail in Section 4.

2.4 GAF Governance

The Board of ZILL is responsible for managing the with-profits business, including setting dividend rates. ZILL has established procedures in order that the Board can satisfy itself at regular intervals that the GAF funds are being managed in accordance with the PPFM.

3. GUIDING PRINCIPLES

3.1 Introduction

ZILL applies a number of Guiding Principles to the management of the GAF fund. These Guiding Principles are considered when applying the specific principles and practices set out in later sections of this document. In the event that there is a conflict between the Guiding Principles and one or more of the specific principles or practices, the Guiding Principles take precedence.

Responsibility for managing the business of the GAF fund in accordance with the Guiding Principles and the other principles set out in this document lies with the Board of ZILL. In making decisions in this regard, the Board will take account of the advice of the Actuary.

The Guiding Principles set out below refer to a number of concepts used in the management of the business, such as 'smoothing'. These terms are explained in more detail in later sections of this document.

Although the Board will use reasonable endeavours to ensure that ZILL abides by these Guiding Principles, in extreme adverse circumstances it may be necessary to depart from these principles in order to minimise any financial risks to the GAF funds. It may also be necessary from time to time to modify the Guiding Principles to reflect any changes in the legislation or regulations governing ZILL's business.

3.2 Guiding Principles

The Guiding Principles, in the order of precedence in which they apply, are as follows:

- (1) ZILL will manage its entire business in a sound and prudent manner and in accordance with its Memorandum and Articles of Association, with the objective of ensuring that all relevant legal and regulatory requirements will be met.
- (2) ZILL will manage the GAF funds with the objective of ensuring that all guaranteed benefits in respect of policies in the Fund, including dividends declared to date, can be paid as they fall due from the available resources of the Fund.
- (3) ZILL will manage the GAF funds with the objective of providing fair treatment for all policyholders in the Fund, having regard at all times to the relative interests of

policyholders and shareholders, the level of guaranteed benefits and the available financial resources of the Fund. In particular, ZILL will aim to achieve a fair distribution of the assets of the GAF funds over the remaining lifetime of the policies in the Fund. The interpretation of what constitutes 'fair' treatment will be determined and reviewed by the Board from time to time taking into consideration, amongst other things, past communications from the Company to policyholders, relevant guidance from any regulatory bodies and what the Board understands to be typical market practice for similar funds, and 'fairness' will be applied across broad groups of policyholders and generations of policyholders.

- (4) A degree of smoothing and approximation will be applied when determining the amounts payable on claims to even out the impact of favourable and unfavourable experience over time and to reflect the pooled experience of different policies and different policy groups within the GAF funds. ZILL will aim to manage the cost of smoothing within the available financial resources of the Fund over the medium term. The degree to which smoothing and approximation are applied may vary, particularly in unusual or exceptionally adverse circumstances.
- (5) In the event that the Board, having regard to advice from the Actuary, considers that the available resources of the GAF funds are insufficient to meet the above objectives, ZILL may supplement the resources of the GAF funds with temporary or permanent financial support from the SH fund, provided that such financial support is made available on financial terms which the Board considers to be reasonable from the point of view of the GAF funds.
- (6) The assets of the GAF funds will not be used to provide any financial support to the other funds within the LTBF except to the extent required or permitted by law in the event of insolvency or if, in the opinion of the Board, there is a serious risk of insolvency. If the Board deems such financial support to be necessary, it will make all reasonable efforts to ensure that such support is provided on terms that minimise, so far as possible, any financial disadvantage to policyholders in the GAF funds.
- (7) The assets of the GAF funds will not be used to provide financial support to the SH fund or to any other company within the ZFS Group under any circumstances within the control of ZILL.

- (8) ZILL will document the underlying approach, methodology and assumptions used in the management of the GAF funds in sufficient detail to ensure that it can apply these Guiding Principles consistently over time.
- (9) ZILL will not normally change the approach, methodology or assumptions underlying these Guiding Principles. Examples of circumstances where the Board might consider such a change include, without limitation, those which would serve to:
- protect the financial position of the GAF funds as necessary in adverse circumstances;
 - improve the accuracy of the methods used;
 - correct any material errors;
 - ensure compliance with changes in taxation, regulation or regulatory guidance; or
 - make appropriate allowance for any previously unidentified influencing factors.
- (10) The Board of ZILL may from time to time determine alternative strategies for the management of the business of the GAF funds including consideration of third-party outsourcing arrangements, but in taking any decisions in respect of such strategies due attention will be given to the interests of the policyholders of the GAF funds.

3.3 Practice

3.3.1 *Types of charges*

For policies in the GAF funds, costs of administration and investment management are applied as specific charges defined in the policy structures.

The costs of providing risk benefits, such as life cover and critical illness cover, are similarly applied as specific charges defined in the policy structure.

3.3.2 *Reviews of the charging basis*

ZILL reviews the position with regard to charging expenses and other costs regularly, and makes appropriate changes from time to time.

4. MANAGEMENT OF THE ESTATE

4.1 Principles

- (1) ZILL's objective is to ensure a fair and orderly distribution of all the assets in the GAF funds, including the Estate, over the remaining lifetime of the policies in force in the Fund. In managing this objective, the Company will take into account the relative interests of policyholders and shareholders.
- (2) The Company will aim to manage the timing of the distribution of the assets of the Fund in such a way that at all times the available financial resources of the GAF funds are adequate to meet the expected level of benefits, including any underlying guarantees. However, the Company will also aim to manage the Estate within reasonable bounds in relation to the financial interests of the remaining in-force policies, so as to control, as far as possible, excessive growth in the Estate.
- (3) Subject to the above, there are no restrictions imposed upon the Company in relation to management and distribution of the Estate.

4.2 Practice

4.2.1 *The Estate*

The Estate is the difference, if any, between the total value of the assets in the GAF funds and the value of assets needed to support the current and future liabilities of the Fund. The liabilities of the Fund include, principally:

- guaranteed liabilities;
- liabilities in excess of guaranteed liabilities arising from the expectation that future dividend payments will be made in accordance with the principles and practices set out in this document, including making allowance for smoothing;
- the cost of the shareholders' share in respect of future dividend distributions;
- current liabilities, such as pending claim payments and other amounts accounted for but not yet received or paid out; and
- any other financial costs arising from the management of the GAF funds.

4.2.2 Management of the Estate

ZILL's objectives is to achieve medium term guaranteed investment returns for the policies investing in the GAF funds over the remaining lifetime of the policies in force. This means that both the assets needed to support current and future liabilities and the assets comprising the Estate are taken into account in determining the level of payouts on policies in the GAF funds.

ZILL manages this by periodically considering the current and projected future position of the assets and liabilities of the GAF funds based on what it believes to be realistic assumptions for future experience. The key mechanisms for managing the financial resources of the GAF funds, including the Estate, are the dividend policy and the smoothing policy, i.e. the discretionary elements that ZILL can use to manage the level of payouts from time to time. The Company aims to set current and future payout levels from time to time such that the value of those payouts (discounted to the present day and allowing for guaranteed minimum amounts, the cost of the shareholders' share of dividend distributions and any other appropriate adjustments) is approximately equal to the total financial resources of the GAF funds including the Estate. By adopting such an approach, ZILL expects the Estate to run down to zero over time broadly in line with the run-off of the business in the Fund.

4.2.3 Management of the GAF funds in the future

A with-profits fund depends on having a certain level of Estate in order to be able to apply smoothing. However, it is more difficult to apply smoothing over the short term than the long term, and for a small fund rather than a large fund. There are therefore conflicts between the orderly distribution of the Estate and the maintenance of an adequate smoothing approach. Further, the level of maintenance expenses per policy may well begin to increase by more than would otherwise be typical as the fund becomes smaller.

For these reasons, were the assets of the GAF funds to reduce to less than GBP100 million the Board of ZILL, acting on the advice of the Actuary, may elect to convert the then remaining policies in the GAF funds to guaranteed dividend, non-profit business.

In this case, ZILL will determine fixed dividend rates such that the available assets in the GAF funds will be distributed to that business over the remaining life of the policies in force, based on reasonable assumptions determined by the Actuary. The fixed dividend rates determined will take account of the relative interests of different types of policyholders and /

or shareholders in a fair manner consistent with the approach that was adopted previously. The assets in the GAF funds will be invested in appropriate fixed interest assets to provide an appropriate stream of income and capital to support the policy payments as they arise and surrender value payouts will be reviewed and adjusted as considered appropriate.

The purpose of such an exercise is to provide protection to policyholders should the GAF funds become too small to manage effectively on a with-profits basis.

4.2.4 *Investment strategy for the Estate*

The investment strategy for the Estate is currently the same as for the other assets in the GAF funds, and the mix of assets in the Estate reflects the mix of assets in the GAF funds as a whole. Alternative investment strategies for the Estate may be followed if the Company deems this to be in the interests of the policyholders in the GAF funds.

4.2.5 *Shareholder support*

Although the Company expects to be able to manage the GAF funds including the Estate over time such that it will not require additional capital support, in adverse circumstances it may be necessary to call upon temporary or permanent capital support from the SH fund. The Board may apply financial support from the SH Fund, provided that such financial support is made available on terms which the Board considers to be reasonable from the point of view of the GAF funds.

5. AMOUNTS PAYABLE ON CLAIMS

5.1 Principles

- (1) Amounts payable on maturity or death under a policy will not be less than any guaranteed amounts payable under the circumstances in which the claim arises, as set out in the policy conditions.
- (2) Surrender values will be determined from time to time by the Company and reviewed regularly. Except to the extent, if any, set out in the policy conditions, surrender values are not guaranteed. Where there is any conflict between the interests of those policyholders effecting a surrender and those remaining, priority will normally be given to the latter.
- (3) ZILL will aim to apply smoothing to claims payments by means of the dividend mechanism. The degree to which smoothing can be applied from time to time will depend on the current and projected future financial position of the GAF funds.
- (4) Amounts payable on surrender claim other than at a Permitted withdrawal point may be reduced by the application of an MLA. MLAs, if applied, will be set having regard to the financial circumstances of the GAF funds at the time of the claim.

5.2 Practice

5.2.1 *Determination of payouts on maturity*

ZILL's objective is to achieve medium term guaranteed investment returns for the policies investing in the GAF funds over the remaining lifetime of the policies in force. The amount payable on maturity will be the value of the Guaranteed Accumulation Account, that is the amount of GAF fund allocated to the Policy, including dividends, net of accumulated charges.

5.2.2 *Factors influencing surrender values*

The amount payable on surrender will be the value of the Guaranteed Accumulation Account, that is the amount of GAF fund at the time allocated to the Policy, including dividends, net of accumulated charges, less an Encashment Deduction. The Amount of the Encashment Deduction is determined by the Company having regard to Expense

Recoupment Charges and financial circumstances at the time. Other than at a Permitted Withdrawal Point, the Company may also apply a Market Level Adjustment. MLAs on surrender are kept under regular review and may change several times a year in response to changing market conditions.

5.2.3 *Amounts payable on death claims*

The amount payable on death will be the value of the Guaranteed Accumulation Account or, if greater, the amount of any guaranteed sum assured on death.

5.2.4 *Documentation of methodology and assumptions*

ZILL maintains detailed records of the methods and assumptions used in the calculation of claim amounts, along with the systems used to implement these methods and assumptions. The Company considers that these records are suitable for the purpose of documenting how claim amounts in general are derived.

6. DIVIDEND POLICY

6.1 Principles

- (1) Dividend rates will be determined by the Board, having regard to the advice of the Actuary.
- (2) All dividend rates will be reviewed regularly by the Company and revised when appropriate. A formal declaration of annual and interim dividend rates will be made at least once in each calendar year.
- (3) Different interim and annual dividend rates may be declared for different groups of policies to reflect the characteristics of those policies in a manner which the Company considers to be fair for all policyholders.
- (4) Interim and annual dividend rates will be set such that they move on a path towards the levels which the Company believes to be sustainable in the medium term, and, in particular, until the next Permitted withdrawal dates of the policies, consistent with the sound and prudent management of the GAF funds as a whole, including the requirement of being able to meet all guaranteed benefits as they fall due. While the Company will aim to ensure a smooth progression of interim and annual dividend rates from year to year, there are no constraints on the level of change in dividend rates and large changes may apply in unusual or adverse circumstances. Interim and annual dividend rates may be zero.

6.2 Practice

6.2.1 *General approach to determining dividend rates*

ZILL's general objective is to develop interim and annual dividend rates which move on a smooth path towards the levels which it believes to be sustainable in the medium term. In making this assessment, the Company takes account of trends in recent economic experience and the expected future investment return on the assets of the GAF funds.

As part of the process for determining the rates of interim and annual dividend, ZILL considers the current and projected financial position of the GAF funds using financial projections based on what it considers to be realistic assumptions for future experience in respect of factors such as investment returns, expenses, surrender rates, mortality and tax.

From this, a range of possible dividend rates is established. Based on these investigations, interim and annual dividend rates are set at cautious, affordable levels. If the eventual outcome is such that a higher level of dividend could have been paid, any excess is available to support the Estate. Similarly, at times the Company may apply part of the Estate to provide temporary support to dividend levels if the eventual outcome is less than expected. The Company does not apply any specific rules relating the levels of interim dividend to the rates of returns on particular asset classes. In carrying out these investigations, close attention is paid to the need to meet policyholders' guaranteed benefits, both currently and in the future.

6.2.2 *Frequency of review of dividend rates*

Annual dividend rates are reviewed annually. Interim dividend rates will be reviewed at least annually, and may be changed (including being set to zero) at any time. ZILL may review these rates more frequently (in which case it undertakes to inform policyholders of any change as soon as practicable thereafter).

6.2.3 *Changes in dividend rates from year to year*

Under normal circumstances, ZILL aims to change typical rates of interim or annual dividend declared from one year to the next by not more than 0.5%. However, in extreme adverse conditions, larger changes may need to be applied, and interim and annual dividends could be reduced or suspended if the Company considered it necessary to do so in order to ensure that the overarching principle of meeting policyholders' guaranteed benefits can be met in practice.

6.2.4 *Changes in dividend rate scales*

Although the Company aims to keep the number of different interim and annual dividend rate scales at a manageable level, it retains the discretion to apply different scales from time to time to different groups of policyholders. This is in order to maintain equity between the different groups, and will take account of factors such as:

- the type and level of charges built in to the premium basis for policies in each series;
- the assumed underlying investment mix (and, especially, currency differences);
- any guaranteed levels of investment return.

7. SMOOTHING

7.1 Principles

- (1) Subject always to the overriding constraint of maintaining the adequacy of the financial resources of the GAF funds so that they are sufficient to meet the payment of guaranteed benefits as they fall due, smoothing will be applied to payouts through the dividend mechanism.
- (2) In unusual circumstances, the Company may apply a lesser degree of smoothing than it would typically expect to apply, in order to provide for fair treatment for all policyholders. In particular, in adverse circumstances, a lesser degree of smoothing may be applied to protect the financial condition of the GAF funds.

7.2 Practices

7.2.1 *Smoothing*

ZILL regards smoothing as a normal part of the operation of the GAF funds. Essentially, smoothing reduces the impact on claim payments of short-term fluctuations in asset values and other factors affecting the business.

ZILL applies smoothing by means of the dividend mechanism, including, in normal circumstances, changing interim and annual dividends levels annually rather than more frequently, limiting the changes from year to year in dividend levels and setting dividend scales which apply to groups of policies rather than individual policies.

7.2.2 *Types of smoothing*

The main types of smoothing can be summarised as follows. ZILL will not always be in a position to apply any or all of these types of smoothing at a given time, as the extent to which smoothing can be applied from time to time depends on the available financial resources of the GAF funds. A lesser degree of smoothing is likely to be applied in adverse or exceptional circumstances.

7.2.2.1 Smoothing within groups of policies

The same dividend rates are applied to similar policies within a group of policies (that is, a group of policies with similar characteristics, for example all policies of a particular type with a given term or duration) irrespective of, for example, the age of the policyholder, the policy size or the exact issue date within a calendar year.

7.2.2.2 Smoothing across groups of policies

Crude dividend rates will be set for groups of policies with similar characteristics as described above. Similar calculations will be carried out to determine the crude dividend rates for different groups of policies of the same type but with different terms or durations. The Company aims to smooth the payouts across the whole group of policies, and adjusts the crude dividend rates accordingly in arriving at a final dividend scale. For example, the Company may determine dividend rates such that maturity values for policies of the same type maturing in a given year follow a smooth progression across policies of different durations in force.

7.2.2.3 Smoothing of interim and annual dividend rates

The Company aims to set interim and annual dividend rates consistently with current investment conditions, having regard to its assessment of medium-term sustainable rates, although it does not apply any specific rules relating dividend levels to the returns on particular types of assets. However, where a change in current dividend rates is considered necessary, the Company aims to limit the amount of such changes year on year in order to smooth dividend rates up or down towards the medium-term rates which it considers to be appropriate.

7.2.3 Current smoothing criteria

The amount of smoothing that the Company deems appropriate for a particular group of policies is typically determined by reference to:

- the absolute percentage change in payouts over the period on similar policies;
- the investment performance over the period of the assets in the GAF Funds notionally allocated to that group of policies.

7.2.4 *Limits on smoothing*

As noted above, the ability of the Company to apply smoothing depends on the available financial resources of the GAF funds. Smoothing may be limited in adverse economic conditions so as not to put the overall financial condition of the GAF funds at risk.

Generally, smoothing is applied in a broadly consistent manner across all policy types and between different generations of policyholders. The degree of smoothing may vary for different classes of business, reflecting factors such as the mix of assets associated with each group of policies, whether they are single premium or regular premium.

The degree to which smoothing is applied can also vary according to the type of claim in question, and to some extent to policy type. Typically a greater degree of smoothing may be applied to maturity claims and death claims, to the extent that the claim amount is not dictated by any guaranteed minimum level of benefits.

8. INVESTMENT STRATEGY

8.1 Principles

- (1) Investment policy for the GAF funds is the responsibility of the Investment Committee of the Board, taking account of advice from the Investment Managers, the Head of the Actuarial Function and the Actuary.
- (2) The investment strategy of the GAF funds will be set having regard to (in order of priority):
 - the current and projected financial position of the Fund and the need to ensure the adequacy of the available financial resources within the Fund;
 - the level and incidence of guarantees in respect of the business of the Fund; and
 - the reasonable investment expectations of all classes of policyholder, having regard to information provided to them, the evolution of investment markets and the financial strength of the Fund.
- (3) Risk will be controlled through selection of assets of appropriate quality and through imposing limits on the amounts of any one asset or the amount of exposure to any given third party. The criteria to be adopted in this regard will be determined by the Investment Committee and followed, so far as is reasonably practicable, by the Investment Managers.
- (4) Certain assets may be notionally allocated to different sub-groups of policies within the GAF funds where the Investment Committee deems it appropriate to do so to reflect the type, extent and timing of guarantees or any other significant differences in the underlying nature of such different sub-groups. The investment strategies in respect of such assets will be determined so as to reflect the different requirements of the associated sub-groups of the business.

8.2 Practice

8.2.1 *Investment objectives*

The assets of the GAF funds are currently managed by Threadneedle Asset Management Limited, a former member of the Zurich Financial Services group.

The current overall investment objective is to satisfy the matching strategy and, subject to that, to achieve returns in the medium term relative to market-index benchmarks agreed with the Company's Investment Managers. Investment Managers are permitted to use a range of fixed interest type assets, such as government bonds and corporate bonds, as well as cash appropriate to the currencies for each of the individual GAF funds.

The investment mix for the assets notionally allocated to each separately identified sub-group of policies will have regard to the maturity of the GAF funds and the likely amount and incidence of payouts, particularly in respect of guaranteed amounts where the Company's ability to alter payouts to reflect investment conditions is limited. An appropriate degree of liquidity will be maintained for each notional pool of assets, reflecting the characteristics of the associated policies.

8.2.2 *Review of investment strategy*

Formal reviews of the investment strategy will be held at Board level at least annually. More frequent reviews may be required following substantial changes in market conditions.

In addition, regular quarterly meetings will take place between the Investment Committee and the Investment Managers in order to monitor progress in respect of investment policy and to consider any appropriate changes.

8.2.3 *Matching of assets and liabilities*

ZILL operates a matching strategy for the assets within the GAF funds whereby certain assets are selected whose values broadly move in line with the values of any underlying guaranteed liabilities in response to changes in investment conditions. Such guaranteed liabilities are typically matched by appropriate fixed interest assets.

Assets selected for matching specific guaranteed liabilities will usually be fixed interest type assets of similar term and currency to the liabilities so as to ensure that they provide appropriate funds as required to meet the cash flow requirements of the GAF funds.

8.2.4 *Investment in different asset classes*

The Investment Managers will normally only invest in assets of suitable quality, including those with a good or very good security rating, but may continue to hold investments whose security ratings have fallen to some extent in order to avoid capitalising losses unnecessarily. The investment benchmarks include specific criteria for liquidity. In practice, the assets in the GAF funds as a whole include a substantial amount of government bonds, and therefore the liquidity criteria are comfortably met.

8.2.5 *Use of new types of investments*

Unless covered specifically in the investment benchmarks, the use of new types of investments is not normally permitted without specific approval of the Investment Committee of the Board.

8.2.6 *Non-tradable assets*

The GAF funds do not have any significant holdings of non-traded investments. Any proposal to invest in non-traded investments to any substantial extent requires the approval of the Investment Committee of the Board. ZILL itself has a number of subsidiary companies. These form part of the assets of the SH fund, and the GAF funds therefore has no interest in any profits (or losses) from those companies.

8.2.7 *Use of Derivatives*

The Investment Committee may from time to time instruct the Investment Managers to consider the use of derivatives. Derivatives are used, for example, as part of efficient portfolio management, to provide some protection against adverse market movements or, where appropriate, to protect the financial condition of the GAF funds and the security of policyholders' benefits.

Derivatives include put and call options, interest rate swaps, foreign currency futures and other instruments which give the holder the right to exercise a defined option to buy or sell assets at a particular price and a particular time. Derivatives can be bought and sold, but they only have value to the extent that the option gives the holder an advantage relative to direct investment in the market. They are useful for protecting the Fund against adverse movements in asset values or yields, but equally they can act to restrict the benefit to the Fund of significantly positive asset value changes.

9. EXPOSURE TO BUSINESS RISK

9.1 Principles

- (1) The Board will aim to minimise business risks in relation to the business of the Company and the GAF funds through regular monitoring of risks and by promptly taking appropriate actions to reduce risk exposure, such as by changes in investment strategy, use of reinsurance or use of derivatives to provide appropriate hedging or the outsourcing of administrative or technical work to suitably qualified third parties.
- (2) Other than in respect of normal levels of investment risk resulting from the management of the assets of the Fund, no new risks of a material nature will be taken on by the GAF funds.

9.2 Practice

9.2.1 *Risk Management Committee*

ZILL has delegated day-to-day management of the major risk factors affecting the business to a Risk Committee appointed by the Board. This committee will monitor experience in relation to the major risk factors. The committee will also seek promptly to identify any new risks which may emerge and which become significant.

The Risk Committee is required to report to the Board on a quarterly basis.

9.2.2 *Major risks*

The most significant of the business risks that have been identified for the business of the GAF funds are set out below, along with the actions that have been taken to mitigate these risks. Each of the risks described can influence the amount and timing of the surplus that emerges in the GAF funds. As stated elsewhere in this document, the maintenance of adequate financial resources within the GAF funds is considered paramount, and appropriate action will be taken to minimise the potential impact of these risks.

9.2.2.1 *Guarantees associated with with-profits policies*

Contractual guarantees apply to most policies in the GAF funds. They include guaranteed minimum amounts on payouts on maturity and death, as well as on surrender on certain

defined events (such as Permitted withdrawal points when no Market Level Adjustment can be applied).

As dividend additions are applied, the underlying level of these guarantees increases. ZILL manages this by limiting the build up of these guarantees, for example by applying dividend rates over time at rates which it considers can be adequately supported by the financial resources of the GAF funds.

9.2.2.2 *Investment risks*

There are a number of types of investment risk – the most relevant for the business of the GAF funds are likely to be falls in fixed interest yields and defaults on corporate bonds. ZILL attempts to manage these risks through the investment strategies it adopts for different groups of policies, as described in Section 8, including matching liabilities with fixed interest assets of appropriate term, investing only in corporate bonds of appropriate quality and investment in fixed interest assets in a manner which it considers appropriate to support the levels of guaranteed benefits in the business.

9.2.2.3 *Miscellaneous business risks affecting the with-profits business*

Miscellaneous risks affecting the GAF funds include risks related to expense levels, mortality and taxation, as well as regulatory risk. The expense risk is largely under the control of the Company, and ZILL will only allocate expenses to the GAF funds in a manner which it considers to be fair and reasonable. The other types of risk are largely outside the Company's control, but ZILL has allocated explicit accountabilities to key staff to monitor and manage such risks.

9.2.2.4 *Potential compensation claims in respect of allegations of misselling*

ZILL aims to ensure that management actions are consistent with sales literature and any subsequent communication with policyholders. In the event that there are any costs arising in ZILL associated with misselling of business in the GAF funds, these will be met from the SH fund, i.e. they will affect shareholders' interests rather than those of policyholders.

9.2.3 *Impact of risks on payouts*

Generally, any adverse impacts of business risks are not applied directly to the calculation of individual policy values, but instead the cost of risks is allocated to the Long Term Business Fund as a whole.

To the extent that the ability of ZILL to smooth payouts as described earlier in this PPFM document depends on the overall financial strength of the GAF funds, policies may be affected by the impact of any risks. The effect of any adverse outcome is likely to be in the form of a lower degree of smoothing and faster reductions in average payout. Generally, the cost of any such risk will be spread over time across different policies and generations of policies, whether making claims currently or continuing in the Fund. There is no specific minimum size for any risk before it is applied in this way.

If a risk arises which is related closely and exclusively to a particular policy type or generation, then it may not be fair to allocate the cost of this risk to all policyholders. In this case, the Company may apply some or all of the cost of this risk to the policies in question, provided that to do so is consistent with the policy conditions and any legal judgements.

9.2.4 *Impact of external risks*

Risks arising in the Company's other business will not affect policies in the GAF funds. An exception to this might arise in the event of extreme adverse investment conditions, such that the GAF funds needed to call upon financial support from the SH Fund.

10. AMENDMENTS TO THE PPFM

10.1 Amendment to the Principles

The Board of ZILL may amend the Principles set out in this document if they reasonably consider, having taken the advice of the Actuary, that:

- (a) the Principles that applied prior to the amendment could lead to unfair treatment of some classes or groups of policyholders within the GAF funds or prevent the sound and efficient financial management of the business in the Fund; or
- (b) the Principles as amended would achieve a better balance of fair treatment in respect of all classes or groups of policyholders, and not increase or introduce the possibility of unfair treatment in respect of any particular classes or groups of policyholder.

The Company will make reasonable efforts to notify all policyholders of any change in the Principles contained in this document at least three months prior to the effective date of such change.

It is expected that the Principles would only need to be amended infrequently.

10.2 Amendment to the Practices

This section covers changes to practices, methodology, controls and material assumptions.

The Board will periodically seek confirmation that the Principles and Practices set out in this document are being implemented appropriately. The Board will also receive regular advice from the Actuary, part of whose responsibilities will be to monitor regularly the methodology, assumptions and controls as they apply in practice.

If, having taken advice, the Board determines that a change to Practices is appropriate, it may delegate the determination and implementation of the changes in detail to a specified group of senior managers (including a qualified actuary from either the team of the Actuary or Company's Actuarial Function, and including managers whose teams or accountabilities are affected by the proposed changes). One or more individuals from this group will be given explicit responsibility for:

- (a) Documenting changes to the PPFM and ensuring that all previous versions of the PPFM are kept for at least six years;

- (b) Ensuring that the revised procedures and systems are properly documented;
- (c) Ensuring that the implementation of the change(s) is properly managed, with appropriate change controls;
- (d) Ensuring that policyholders (and, if appropriate, the Regulator) are notified of changes to practices, including, where relevant, making details of changes on the Company web site within a reasonable timescale and ensuring that policyholders are given written details of changes in their next appropriate mailing from ZILL.

Collectively, the group will be responsible for:

- (a) Determining and agreeing the fine details of the proposed changes;
- (b) Referring back to the ZILL Board if issues cannot be resolved or if it is felt to be appropriate for the ZILL Board to discuss and agree the finer details.

APPENDIX A – GLOSSARY

GAF funds	The various sub-funds of the Long Term Business Fund described as such where profits or losses arising are distributed to policyholders by way of dividend additions.
Actuarial function	The function with responsibility for advising the Board of the Company on the actuarial management of the business.
Actuary	A Fellow of the Faculty of Actuaries or the Institute of Actuaries.
Annual dividend	A dividend which is added on a regular basis throughout the life of a policy by increasing the number of the GAF fund units allocated to the policies.
Dividend	The means by which the policyholders' share in the profits arising in a GAF fund are allocated to policies. Dividend levels are not guaranteed in advance.
Company	Zurich International Life Limited
Estate	The assets in a GAF fund held in excess of those required to back the expected liabilities of that fund, including payments of future dividends and any liabilities which arise from the Company's regulatory duty to treat policyholders fairly.
Guaranteed benefits	The guaranteed minimum level of benefits payable on a claim under a life insurance or pension policy, as defined in the policy conditions . Different levels of guaranteed benefits may apply in different circumstances, such as on death or at maturity .
Interim dividend	A dividend other than an annual dividend .
Long Term Business Fund (LTBF)	The sub-fund of the Company that holds the assets available to meet the liabilities under the Company's long-term life and pensions policies.
Market Level Adjustment (MLA)	The Market Level Adjuster (MLA) is a charge that is applied to withdrawals from the GAFs that are taken outside of permitted withdrawal point. The MLA exists in order to protect those investors who maintain their holding in the GAF until the 10-year anniversary or a permitted withdrawal point. It is designed to halt any potential dilution of returns for other investors as a result of a client withdrawing early.
Maturity	The payment of policy benefits due on the maturity date

Permitted withdrawal point	Any date as determined by the policy conditions (e.g. on death or maturity) where the policy benefits are payable without application of a market level adjustment .
Policy Conditions	For a given life insurance or pensions policy, the legal document which sets out the respective rights and obligations of the Company and the policyholder.
Shareholder fund	The sub-fund of the Company that is separate to the Long Term Business fund and in which policyholders have no interest.
Smoothing	The practice of managing claim values on with-profits policies such that changes in the claim values do not directly reflect, for example, all of the movements in the value of the assets in the underlying GAF fund . Smoothing also applies as a form of averaging claim payments over groups of policies in a fund.
Surrender	The payment of policy benefits that discharges any future liability on the part of the Company to pay the guaranteed benefits under the policy, such as those payable on maturity or death. Surrender terms are not usually guaranteed.

Important information

Please remember that past performance is not a guide to future performance. The value of any investment and the income from it can fall as a result of market and currency fluctuations and you could get back less than the amount originally invested.

Zurich International Life Limited is fully authorised under the Isle of Man Insurance Act 1986 which ensures that the Company has sound and professional management and provision has been made to protect policy owners.

Owners of policies issued by Zurich International Life Limited will be protected by the Isle of Man Life Assurance (Compensation of Policyholders) Regulations 1991 if the Company should be unable to meet its liabilities. Policyholders will not be protected by the UK Financial Services Compensation Scheme.

For full details of the available range of funds and their charges, please refer to the 'Investments - Your guide' and 'Mirror funds - Your guide' booklets, copies of which are available on request.

The value of Guaranteed Accumulation funds is only guaranteed on the 10th anniversary of the Policy Commencement Date or at the policy maturity date, if earlier, and on each following 10 year anniversary.

Zurich International Life Limited is registered (Registration No.63, February 17,1991) under UAE Federal Law No.9 of 1984 and its activities in the UAE are governed by such law.

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For details of the terms and conditions governing the Guaranteed Accumulation funds, please refer to the 'Investments -Your guide' booklet, a copy of which is available on request.

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