



Zurich Assurance Ltd

Principles and Practices of Financial Management of the Zurich Assurance 90:10 With-Profits Business

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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 Assurance Ltd (“ZA” or “the Company”) applies in managing the with-profits business in its 90:10 Fund. This business was originally written by Eagle Star Life Assurance Company Limited (ESLACO). Where this document refers to ZA, this should be taken to mean ESLACO where relevant. The PPFM plays an important role in the governance of with-profits business 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.

A small volume of business written in Malta is reassured into ZA from Eagle Star Insurance Company Limited. This PPFM also governs management of that business.

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 11.1.

Practices are statements of specific practice employed in managing the with-profits business. They reflect ZA’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 11.2.

Section 2 gives a brief overview of the structure of ZA and its with-profits funds, types of with-profits contracts, apportionment of surplus arising, claim values and bonuses, and governance arrangements. Section 3 states the overarching principles for management of the 90:10 Fund. The remaining sections cover specific issues relating to the management

of the with-profits business in the 90:10 Fund. The main body of this document covers the principles and practices relating to the main classes of UK-type policies – certain overseas-type policies and the small number of policies written under the Eagle/Midland banner are covered in Appendices D and E respectively.

This PPFM is a technical document, and it uses several terms which are in common use in life insurance practice. Many of these terms are described in the text in the following sections, and a glossary of the key terms is given in Appendix A.

This is the tenth version of the PPFM. The changes since the previous version are to:

- a) update references to the Asset / Liability Management Investment Committee (ALMIC) and the Risk Committee in sections 7 and 8 following a change to ZA committee structures; and
- b) replace references to the reinsurance of guaranteed annuity options in sections 4, 7 and 8 with the revised investment strategy as the fund has received a payment in exchange for cancelling the reinsurance.

2. OVERVIEW

This section aims to give a high level introduction to the structure of ZA and the operation of the with-profits business. 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 Assurance and its Funds

2.1.1 The Company

ESLACO began operating in 1991 when the life and non-life insurance businesses of Eagle Star Insurance Company Limited were separated and substantially all the existing life insurance business of Eagle Star Insurance Company Limited was transferred into the new company. Since 1999, ESLACO has been a wholly owned subsidiary of Zurich Financial Services (UKISA) Limited (“ZFS”).

ESLACO continued to write new business under the Eagle Star brand throughout the 1990s. Since 2002, it has effectively been closed to new with-profits business, and no new with-profits business is accepted. New investment into the fund in whatever form in respect of existing policies is only accepted where acceptance is a requirement of the terms and conditions of those policies. For the purposes of determining any distribution of the estate, ZA reserves the right to exclude any new investment into the fund that is made after 1 April 2009. It also still accepts small amounts of deposit-administration type business through its Hong Kong branch. The company name was changed to ZA on 1st January 2005 as a result of a court sanctioned scheme of arrangement which included the transfer of other life business of the Zurich group. The company continues to write new non-profit business, mainly protection policies, pension policies and unit-linked bonds.

Most of ZA’s business originates from the UK, although there are also policies in force that were written in Hong Kong, Malta, the Isle of Man and the Channel Islands. The Maltese business and some of the Isle of Man and Channel Islands business has similar terms and conditions to those of the UK policies and is managed by ZA alongside the UK business (the benefits on the Maltese policies are denominated in Euros). The Hong Kong business and the rest of the non-UK business was written on different terms and is largely managed by ZA’s overseas branches. In this document, we have referred to “UK-

type” business and “overseas-type” business to cover the business managed in the UK and overseas respectively. Please refer to Appendix D for a summary of the practices relating to overseas-type business.

There is also a small portfolio of policies still in force within the 90:10 Fund known as Eagle/Midland Unit Policies and Unit Investment Policies. Please refer to Appendix E for a summary of the practices relating to these policies.

2.1.2 Fund structure

ZA consists of four Long Term Business Funds (“LTBF”) and a Shareholder Fund (“SH Fund”). The four long term funds are the 90:10 With-profits Fund (“90:10 Fund”), the 100:0 With-profits Fund (“100:0 Fund”), the Defined Charge Participating fund (“DCP” fund) and the Non Profit Fund (“NP Fund”).

The 90:10 Fund contains conventional with-profits and unitised with-profits business. This business was mostly written prior to 1995, although there is also a relatively small amount of incremental business written more recently. The fund operates on the basis of a 90:10 split of any distributable surplus, whereby policyholders collectively share in 90% of the surplus arising and shareholders are entitled to the remaining 10% via a transfer to the SH Fund.

In 1995, the company launched a new series of unitised with-profits business, which is held in the 100:0 Fund. The shareholders’ interest in this business arises via the difference (if any) between the specific management charges levied by the Company under the policy terms and conditions and all the costs incurred in relation to the business (i.e. the cost of writing and administering the business, including commission related costs, investment management fees and risk benefit claims). All of the investment returns after charges, less any applicable taxation, will be distributed over time to the policyholders in the 100:0 Fund in the form of guaranteed benefits or bonus. There is no overseas-type business in the 100:0 Fund.

The DCP Fund and NP Fund contain non-profit conventional and unit-linked business. Unit-linked policyholders’ benefits are determined by the value of units they hold, which depends on the investment returns on the assets of the unit-linked funds less charges and taxation. If a surplus arises in any year between 2005 and 2024 inclusive in the DCP Fund then 1 per cent. of that surplus will be transferred to the 100:0 Fund. This transfer is

subject to a maximum of £1m, increasing in line with the UK Retail Prices Index, in any one year. Apart from as described above and the support mechanism described in Appendix C, all profits from the business in the DCP fund and NP Fund belong to shareholders. Policyholders' benefits are determined by the relevant policy conditions and there is no policyholder participation in profits.

The SH Fund contains assets which belong entirely to shareholders, including amounts built up from past profits or losses from the long-term business. Policyholders have no direct interest in the assets of this fund.

Separate assets are allocated to each of the LTBFs and each fund has its own investment strategy or strategies. Within the 90:10 Fund, different asset mixes are maintained for UK-type business, overseas-type business and Eagle/Midland Unit Policies. Within UK-type business ZA may notionally apply different asset mixes to certain policy groups. The asset mixes of each group are set to reflect different features such as the average outstanding period to the next guarantee date and the type and extent of any guarantees. For the time being the company may maintain separate asset mixes for life business, conventional pensions business excluding Esitran, conventional Esitran business, unitised pensions business, and the assets backing guarantees and the Estate.

ZA manages the four funds such that under normal circumstances only the assets of a given fund are used to meet the liabilities of that fund. This approach has been accepted by the Financial Services Authority ("FSA"), the Company's regulator. However, under insurance company law the LTBFs are counted as one fund and all the assets are theoretically available to meet the liabilities in the fund. The Company recognises this possibility by making financial support available for the 90:10 Fund and/or the 100:0 Fund from the DCP Fund or NP Fund (or, if necessary, from the SH Fund) in certain circumstances (see Appendix C). Financial support in this context means either a transfer or notional allocation of assets other than that which would occur in the normal operation of the business or foregoing an entitlement to a transfer of assets or charge on the with-profits fund, and such support may be either temporary or permanent in nature depending on the circumstances at the time. Other than in extreme circumstances (for example to avert insolvency, as described in Guiding Principle (6) in Section 3) the 90:10 Fund will not provide any financial support for the 100:0 Fund (and vice versa), and neither fund will provide any financial support for the DCP Fund or NP Fund. The 90:10 Fund and

the 100:0 Fund will not be used to provide financial support to the SH Fund under any circumstances.

This document sets out the PPFM for the with-profits business in the 90:10 Fund. A separate PPFM document has been prepared covering the with-profits business written in the 100:0 Fund.

2.2 Sharing of surplus arising in the 90:10 Fund

Surplus arises in the 90:10 Fund from a number of sources. Typically, the primary sources of surplus are the differences between actual investment returns and the investment returns allowed for in valuing the guaranteed benefits to which policyholders are entitled. Surplus arising in a given year can be either positive or negative: a negative surplus is also referred to as a deficit.

Surplus is distributed to with-profits policyholders in the form of bonuses. The amount to be distributed will depend to some extent on the amount of surplus (or deficit) arising. However, this amount may either be increased by including some of the retained surplus from previous years held in the Estate (the Estate is described in 2.3.7 below), or some of the surplus arising may be held back and used to increase the Estate.

Some of the bonus allocated to policies serves to increase the value of current claims, and some is held back to increase the value of benefits in the future. For a given policy, the cost of any bonus added to current claims is effectively a cash amount, whereas the cost of any bonus added to future benefits is a discounted amount which is added to the Company's reserves held in respect of that policy.

Distributions of surplus from the 90:10 Fund are shared between with-profits policyholders and shareholders in the proportions 90% to policyholders and 10% to shareholders. This means that for every £9 which goes towards the cost of bonus allocations to policyholders, shareholders receive £1. From 30 June 2005, any tax liability in respect of a distribution of surplus is attributed to the estate, so asset shares are unaffected. For distributions of surplus made prior to 30 June 2005 any tax liability was attributed to asset shares. From 1 January 2007 any Market Value Reductions (MVRs see 2.3.3) subtracted from policyholder claims will be deducted from the cost of bonus

allocations used to calculate the shareholders' share of surplus. This change will reduce the amount of the surplus allocated to shareholders.

2.3 Operation of With-profits Business

2.3.1 *Types of with-profits contracts*

There are two main types of with-profits contracts within the 90:10 Fund, conventional with-profits ("CWP") policies and unitised with-profits ("UWP") policies. These have very different underlying product structures.

Under CWP policies, there is a guaranteed amount payable on a specified event or date stated in the policy conditions. This may be defined as a single lump sum payment (referred to as a "Sum Assured") or as a series of payments (referred to as an "Annuity" or "Pension"). The guaranteed amount can be increased by the addition of bonuses as described below. A different guaranteed amount may be payable on other events, such as on death.

Under UWP policies, a percentage of the premiums paid is allocated to with-profits units in the 90:10 Fund. On some policy types, units may be cancelled to meet, for example, expense charges, the cost of life cover or other benefits. The allocation percentage and the basis for determining the charges are set out in the policy conditions. The nominal value of the units attaching to a policy (which is the number of units multiplied by the bid price of those units from time to time) forms the basis for determining policy benefits, subject to certain adjustments as described below.

2.3.2 *Bonuses*

Bonuses take two main forms, i.e.:

- Regular bonuses (referred to as "reversionary bonuses" on CWP policies or "annual bonuses" on UWP policies), which are added regularly throughout the policy term. Although reversionary or annual bonuses are not guaranteed in advance, once added they increase the level of guaranteed benefits on a policy and they cannot subsequently be taken away provided the policy continues without amendment to death, its maturity or the selected pension date. When a claim arises between dates on which the Company has formally declared a regular

bonus, an “interim” bonus may be added to the claim amount which allows for partial accrual of some or all of the expected regular bonus earned in the interim period. However, the rates of interim bonus are not guaranteed.

- Terminal bonuses (also sometimes referred to as “final bonuses”), which are only added at the date of a claim and increase the amount paid out. Terminal bonuses are not guaranteed in advance of a claim, and the rate of terminal bonus payable can be changed at any time.

The levels of bonuses payable on policies in the 90:10 Fund are determined by the Company, and depend on the profits arising in the Fund over time. Where ZA applies separate asset mixes to policy groups within the 90:10 Fund, the investment surplus arising is assessed separately for each group and bonuses set accordingly. It is possible that if profits are insufficient then bonuses in one or more years could be zero.

ZA’s approach to bonuses is described in more detail in Section 5.

2.3.3 Market Value Reductions

In some circumstances, an adjustment may be applied on claims on UWP policies which reduces the claim value to below the nominal value of the attaching with-profits units. Such an adjustment is known as a Market Value Reduction or a Market Valuation Adjustment – in this document we have used the abbreviation “MVR” to refer to either. The Company applies MVRs in order to ensure fairness between policyholders leaving the 90:10 Fund and continuing policyholders.

The Company will normally consider applying a MVR when the market value of the assets backing UWP policies is below the nominal unit value. The rate of any MVR applying from time to time can be varied frequently by the Company and will depend on the financial conditions of the 90:10 Fund at the time. The rate of MVR may be different for different policy types and unit series, and may vary according to the period over which the policy, or any premium increment, has been invested in the 90:10 Fund. A MVR will not be applied if its value is less than £10 or less than 0.5% of the nominal unit value. For partial withdrawals the £10 threshold is reduced prorata by the amount withdrawn compared to the nominal unit value of the policy before that withdrawal. For plans that are made up of individual policies the £10 threshold applies over the total value of all of those policies held.

On some policy types, the Company guarantees that no MVR will be applied in certain circumstances or on certain dates, 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 “Guarantee Date” to refer to any date or event on which a MVR will not be applied. The amount paid out on a claim on a UWP policy on a Guarantee Date will not be less than the nominal value of any with-profits units cancelled to meet the cost of the claim.

ZA’s approach to the application of MVRs is described in more detail in Section 5.

2.3.4 Claim benefits

In general, the circumstances in which claims arise on policies in the 90:10 Fund can be categorised in three ways, i.e. maturities, surrenders and death claims.

For life policies (other than whole-of-life types), the maturity date means the date on which the policy proceeds are finally paid as stated in the policy schedule. For pensions policies, it means the selected pension date stated in the policy schedule. Claim payments at the maturity date will not be less than any applicable guaranteed minimum amount (which may be increased by reversionary or annual bonuses). Maturity claim payments may also be increased by interim bonuses and/or terminal bonuses, but will not be reduced by application of a MVR.

Surrender claims occur when a policyholder elects to take some or all of the benefits other than on the contractual maturity date. For example, on pensions policies, early or late retirements are regarded as surrenders, as are transfers to another company. For life policies, partial or full withdrawals other than at the maturity date are classed as surrenders. On whole-of-life policies, any claim other than a “death claim” is a surrender claim, as there is no contractual maturity date. Surrender claim payments are generally not guaranteed in advance. They may be increased by interim bonuses and/or terminal bonuses or, in the case of UWP policies and partial or total surrenders of CWP group deferred annuity pension schemes, reduced by application of a MVR.

We have used the term “death claims” generally in this document to describe claims on death or on certain other events, such as diagnosis of a defined serious illness. Death claim benefits depend on the contractual terms of each policy type, as defined in the

policy conditions. They may be increased by interim bonuses and/or terminal bonuses, but will not be reduced by application of a MVR.

The way in which ZA determines the appropriate amount of payouts in respect of claims of each type from time to time is described in more detail in Section 4.

2.3.5 Smoothing

ZA regards smoothing as a normal part of the operation of with-profits business. 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. ZA applies smoothing by means of the bonus mechanism, including, for example limiting the changes from year to year in bonus levels and setting bonus scales which apply to groups of policies rather than individual policies.

The degree to which ZA can reasonably apply smoothing depends on the available financial resources of the 90:10 Fund, and in adverse circumstances the Company may substantially amend its smoothing criteria, or substantially reduce the degree of smoothing, in respect of certain (or all) groups of policies. Where smoothing is applied, it works both within groups of policies (for example, where the payouts may not reflect exactly the characteristics of an individual policy and its contribution to the 90:10 Fund) and across different periods (for example, where changes in payouts from year to year may be less than changes in the value of the underlying assets).

ZA's approach to smoothing is described in more detail in Section 6.

2.3.6 Investments

ZA uses a mix of investments to support the with-profits business in the 90:10 Fund, including both equity type assets (such as UK and overseas shares, as well as property) and fixed interest type assets (such as Government 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 the adequacy of the available resources within the 90:10 Fund to meet at least the guaranteed level of benefits using a suitable portfolio of assets with an acceptable level of risk. Within this overall framework the Company allocates different asset mixes to UK-type and overseas-type business, as well as to the Eagle/Midland business. In

addition, ZA may notionally apply separate asset mixes to policy groups within the 90:10 Fund to reflect different features of the groups such as the average outstanding term to the next guarantee date and the level and type of the underlying guarantees.

The investment strategy for the 90:10 Fund as a whole and for different sub-sets of the assets in the Fund is described in more detail in Section 7.

2.3.7 The Estate

The Estate is the difference, if any, between the total assets in the 90:10 Fund and those needed to support the current and future liabilities of the Fund. The amount of the Estate varies according to the Company's assessment of the cost of the future liabilities from time to time, but in a given year it can also be increased or reduced by the allocation of some of the surplus or deficit arising, or reduced to the extent necessary to support bonus levels. In effect, the Estate is the means by which ZA is able to provide a degree of smoothing on the business in the 90:10 Fund.

As the 90:10 Fund is effectively closed to new business (other than the small amount of incremental business referred to above), ZA aims to distribute the whole of the Estate, if any, over the remaining lifetime of the business in force in the Fund. The Estate will be distributed using the bonus mechanism by enhancing asset shares at the time of claim.

The management of the Estate is described in more detail in Section 10.

2.4 With-profits Governance

The Board of ZA is responsible for managing the with-profits business, including setting bonus rates. References to the responsibilities of the Board in respect of different aspects of the management of the with-profits business are given throughout this document, and a broader description of the governance role of the Board is given in Section 11. ZA has established procedures in order that the Board can satisfy itself at regular intervals that the with-profits business is being managed in accordance with the PPFM.

ZA will tell its with-profits policyholders every year whether it has complied with its obligations in the PPFM. The annual report will be published within 6 months of the end of the calendar year covered and gives the opinion of the ZA Board of Directors whether:

- the company has complied with its obligations in the PPFM

- the way it exercised discretion was appropriate
- it has addressed any competing or conflicting rights, interests or expectations of its policyholders and shareholders in a reasonable and proportionate manner.

In particular this concerns the following areas which are described in the report:

- bonus rates
- investment strategy
- surrender values
- expense incurred and charges made
- changes to the PPFM
- communications with policyholders.

In addition a separate report is also required from the With-Profits Actuary giving his or her opinion on whether the company has applied its discretion in a reasonable and proportionate manner.

With effect from 31 December 2004, there has been a specific role of With-Profits Actuary, whose responsibilities will include advising the Board on the exercise of its powers of discretion in the management of the with-profits business. The Board may also call upon advice from other senior managers in the Company with knowledge and experience of the with-profits business. In addition, the Board will refer regularly to another expert or experts from outside the Company in order that it can maintain an appropriate level of independent review to ensure that its management of the 90:10 Fund is consistent with the principles and practices set out in this document (or as subsequently updated from time to time as principles and practices change).

3. GUIDING PRINCIPLES

3.1 Introduction

ZA has determined a number of Guiding Principles for the management of the 90:10 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. ZA believes these Guiding Principles to be consistent with the FSA's Principles for Businesses, but should any conflict arise the FSA's principles would take precedence.

Responsibility for managing the business of the 90:10 Fund in accordance with the Guiding Principles and the other principles set out in this document lies with the Board of ZA. In making decisions in this regard, the Board will take account of the advice of the With-Profits Actuary.

In arriving at these Guiding Principles, the Board of ZA has tried to consider all likely circumstances and conditions that might affect the 90:10 Fund going forward. The Board will use all reasonable endeavours to ensure that ZA abides by these principles. However, it is possible that extreme circumstances could arise such that it may be necessary to depart from these Guiding Principles in order to minimise any financial risks to the 90:10 Fund. It may also be necessary from time to time to modify the principles to reflect any changes in the legislation or regulations governing ZA's business. In such circumstances, the Board will consider what changes to these Guiding Principles are necessary, taking advice from the With-Profits Actuary and others both within and outside the Company as appropriate, and the Board undertakes to keep all affected policyholders informed of any changes.

3.2 Guiding Principles

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

- (1) ZA 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, including, without limitation, those established by the UK regulator in respect of the adequacy of

financial resources supporting the business and those set out in the policy conditions of the business in force.

- (2) ZA will manage the 90:10 Fund with the objective of ensuring that all guaranteed benefits in respect of policies in the Fund, including reversionary and annual bonuses declared to date, can be paid as they fall due from the available resources of the Fund.
- (3) ZA will manage the 90:10 Fund 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, ZA will aim to achieve a fair distribution of the assets of the 90:10 Fund over the remaining lifetime of the with-profits policies in the Fund. The interpretation of what constitutes “fair” treatment for policyholders as a whole will be determined and reviewed by the Board from time to time taking into consideration, amongst other things, communications from the Company to policyholders, relevant guidance from the FSA and what the Board understands to be typical UK market practice for with-profits business, and “fairness” will be applied across broad groups of policyholders and generations of policyholders.
- (4) The Company will aim to reduce the volatility of payouts to policyholders through appropriate management of the 90:10 Fund. To achieve this objective, 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 90:10 Fund. ZA will aim to manage the cost of smoothing within the available financial resources of the Fund over the medium to long term. The degree to which smoothing and approximation are applied may vary from time to time.
- (5) Subject to abiding by the principles and practices described in this document, the Company will aim to manage the 90:10 Fund from within the Fund’s own resources. However, in the event that the Board, having regard to advice from the With-Profits Actuary, considers that the available resources of the 90:10 Fund are insufficient to meet those objectives, ZA may supplement the resources of the 90:10 Fund with

temporary or permanent financial support from the DCP Fund, NP Fund or 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 90:10 Fund. The means of providing support to the 90:10 Fund is described in Appendix C.

- (6) The assets of the 90:10 Fund will not be used to provide any financial support to the 100:0 Fund or the DCP Fund or the NP Fund 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 90:10 Fund.
- (7) The assets of the 90:10 Fund will not be used to provide financial support to the SH Fund or to any other company within the Zurich Financial Services group.

ZA will not normally change the approach, methodology or assumptions underlying these Guiding Principles and will take all reasonable steps to ensure that it is able to apply these principles consistently over time. However, there may be circumstances where, in the opinion of the Board, changes to these Guiding Principles and their application in practice might be necessary. 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 90:10 Fund 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.

Appendix B, paragraph B.5, sets out in more detail the circumstances in which changes may be made.

4. AMOUNTS PAYABLE ON CLAIMS

4.1 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 with the aim of maintaining equity between policyholders leaving the Fund and those remaining. Except to the extent, if any, set out in the policy conditions, surrender values are not guaranteed.
- (3) Except in circumstances where they are determined by reference to guaranteed amounts, ZA will aim to apply smoothing to claims payments by means of the bonus 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 90:10 Fund. The degree of smoothing applied to surrender payouts is likely to be less than that applied to payouts on maturity or death claims.
- (4) Amounts payable on maturity, surrender or death claims may be increased by the application of an interim bonus and/or a terminal bonus. For UWP policies and in the case of partial or total surrenders on CWP group deferred annuity pension schemes, the amount payable on a surrender claim other than at a Guarantee Date may be further reduced by the application of a MVR. For all policy types, terminal bonuses and MVRs, if applied, will be set having regard to asset shares, the underlying level of guarantees and the financial circumstances of the 90:10 Fund at the time of the claim. Appendix B sets out in more detail how asset shares are calculated.
- (5) As a consequence of the degree of approximation inherent in the application of bonuses, MVRs and smoothing, ZA will determine payouts having regard to the average levels of benefits across groups of policies rather than to individual policies, except in respect of policies where guaranteed minimum payout levels apply.
- (6) Changes to the methods used to determine the amounts payable on claims are approved by the Board, taking account of the advice of the With-Profits Actuary.

4.2 Practice

The following paragraphs describe ZA's practice in respect of the amounts payable on maturity claims, surrender claims and death claims.

The practices described reflect those that have been approved by the Board at the time of writing this PPFM. From time to time, the Board, having taken advice from the With-Profits Actuary, may approve changes to ZA's practices in respect of claims, in which case such changes will be implemented as soon as reasonably possible subject to satisfactory completion of any necessary changes to administration systems.

In the event that it is necessary to change the bases for calculating claim amounts due to changes in the circumstances of the 90:10 Fund, then such changes may be applied subject to the approval of the With-Profits Actuary, but the Board will review the changes at the next available opportunity.

In either case, all policyholders affected by a change in practice will be informed of the revised practice with their next appropriate mailing from ZA, as described in Section 11.

For a summary of the practices relating to overseas-type business and Eagle/Midland Policies, please refer to Appendices D or E respectively.

4.2.1 Amounts payable on maturity

4.2.1.1 Components of a maturity claim

The amounts paid on claims at maturity on with-profits policies (referred to more generally below as "payouts") are made up as follows:

- On CWP policies, as the sum of the guaranteed amount and the reversionary bonuses added during the term of the contract to date, plus any interim and/or terminal bonus that may be added at the date of claim. On some types of pensions policies, the maturity benefits are payable as an annuity rather than a lump sum and any interim or terminal bonus increases the initial amount of the annuity.
- On UWP policies, as the value of the with-profits units at the quoted bid price, increased by any terminal bonus that may apply at the time of the claim. MVRs are not applied to payouts at maturity.

The one notable exception to the above is in respect of policies linked to Series 1 UWP units. The nature of the underlying guarantee on these policies is very different from that on other UWP business, and for this reason the maturity value (and surrender value) basis for such policies is described separately at the end of this Section.

4.2.1.2 Determination of payouts on maturity

As the 90:10 Fund is closed to new business, other than for a small amount of incremental business, the financial resources available to meet payouts are finite. One of ZA's objectives is to achieve an orderly run-off of these resources over the remaining lifetime of the policies in force.

ZA manages this by periodically considering the current and projected future position of the 90:10 Fund based on what it believes to be realistic assumptions for future experience. The process is described in more detail in Section 10, but essentially it involves setting aside sufficient assets to meet the expected level of guaranteed benefits and applying the balance of the assets to provide benefits in addition to the existing guaranteed benefits in a manner consistent with the principles and practices set out in this document.

In applying such an approach, ZA has regard to the current and projected future level of asset shares on with-profits policies. "Asset shares" are described in more detail in Appendix B, but essentially they represent the accumulated contribution of each policy to the 90:10 Fund and may include allowance for an enhancement as a result of the distribution of the Estate. ZA estimates the level of maturity payouts as a percentage of asset shares that it expects to be able to sustain over the medium to long term, subject to allowing for any guaranteed minimum payouts on policies which might exceed the underlying asset share. For Whole of Life and certain pension products where there are few policies remaining asset shares are not calculated. The bonus rates for these products are set to those of the most similar product for which asset shares are calculated.

This "target" payout percentage, which represents an average level across all policies, is normally reassessed at least annually and is likely to change from time to time in response to changing conditions and experience (and as indicated below any changes will be reflected in the terminal bonus scales in effect from time to time). More frequent changes in the target payout percentage may be made in periods when investment conditions are changing rapidly. There may be some policies where the guaranteed minimum payout

exceeds 120% of the underlying asset share. For policies where this is not the case ZA targets the level of payout percentages for maturities such that at least 90% of payouts fall between 80% and 120% of unsmoothed asset share.

Whether we are meeting our target is normally reassessed twice a year and is determined by comparing the unsmoothed asset share of each maturing policy to its maturity value.

Under normal circumstances, ZA expects payouts on maturity to be targeted at a percentage of asset shares across the business in the 90:10 Fund as a whole, although in unusual or extreme circumstances a different target may apply. We are currently targeting 100% of asset share (except for Section 32 Esitran policies see below). In practice it may not be possible to achieve payouts that meet this target as a percentage of asset shares at all times. This is because of the impact of, for example, policy terms and conditions (such as the presence of guaranteed minimum benefits), the fundamental nature of with-profits business (as manifested in factors such as the application of smoothing, the grouping of policies of different ages and policy sizes and the bonus mechanism) or the impact of investment market movements. For example, at the time of writing this PPFM, the value of guaranteed minimum benefits on certain policy types (in particular, CWP pensions) exceeds the asset share by a considerable margin; as a result, the actual payouts on such cases are significantly higher than the general target levels of payouts as a percentage of asset share. For Section 32 Esitran policies terminal bonuses have been set so that the maturity values target 100% of asset share at maturity where the asset share allows for the cost of providing guaranteed annuity benefits. However if targeting 90% of asset share at maturity, ignoring the cost of providing guaranteed annuity benefits, produces a higher terminal bonus rate, then this rate is applied.

In addition, as a result of the application of smoothing, at any particular time the actual payout for a given individual policy may be higher or lower than the average target level expressed as a percentage of asset share. ZA's approach to smoothing is described in more detail in Section 6.

4.2.1.3 Application of bonus scales

The actual level of maturity payouts for individual policies will be managed using the reversionary/annual (including interim) and terminal bonus scales.

Bonus scales apply across groups of policies; for example, bonus scales on endowment policies may be based on all policies with a policy term within a given range, irrespective of policy size. This means that although at any particular time the Company aims to make claim payments for each group of policies as a target percentage of asset share on average (provided that the resulting payouts for any individual policy would be at least as high as any applicable guaranteed minimum amounts), payouts for individual policies may not be equal to the target percentage.

4.2.1.4 Factors influencing maturity payout levels

The main factors influencing maturity payout levels are the amount of available assets in the 90:10 Fund, the degree of smoothing being applied and the level of underlying guarantees. These factors are all inter-connected, and in determining the appropriate level of payouts ZA will take all of these factors into account, as well as a number of less influential factors.

Under the economic conditions prevailing at the time of writing this document, the cost of the underlying guarantees (e.g. the sum assured plus bonuses on CWP policies or the nominal unit fund on UWP policies) is a major factor, and it is likely to continue to be so for the foreseeable future. The exposure to variations in the costs of honouring guaranteed annuity options on certain pensions policies is mitigated to a significant extent by investing in fixed interest securities of an appropriate duration and an associated derivative hedging programme. Nevertheless, on certain policy types the value of the guaranteed benefits exceeds the asset shares by a substantial amount.

The operation of smoothing affects the level of maturity payouts, sometimes increasing them and sometimes reducing them, as the name implies. Smoothing is described in more detail in Section 6.

The amount of assets available to provide for claim payments depends to a large extent on the investment returns achieved in the 90:10 Fund, and this in turn depends on the investment strategy adopted for meeting the liabilities of different groups of policies within the Fund. The investment strategy must take account of the underlying level of guarantees for each policy group, and a more cautious strategy will generally be applied when the level of guarantees is higher (relative to asset shares) in order to protect the

financial position of the 90:10 Fund as a whole. Investment strategy is described in more detail in Section 7.

There are a number of other factors which affect the level of surplus arising in the 90:10 Fund and hence the level of assets available to support payouts. These include the level and rate of incidence of death and critical illness claims, surrender profits and losses, the level of expenses charged to the 90:10 Fund and taxation. Generally, such factors will have a smaller impact on the 90:10 Fund than the overall investment return, although the Company does monitor the impact of such factors regularly and takes steps where appropriate to manage the impact of these factors so as to minimise any adverse impact on the Fund.

4.2.2 Surrender values on CWP policies

4.2.2.1 Surrender value calculation

Surrender values for CWP life policies are targeted as a percentage of asset shares. We are currently targeting an average of 100% of asset share. Surrender values for CWP pensions policies are normally derived from recalculation of the policy benefits from inception, as if the policy had been written originally for the term at which surrender is being requested. In the case of partial or total surrenders on CWP group deferred annuity pension schemes, the surrender value may be further reduced by the application of a MVR.

Except for CWP pensions policies where the surrender value calculation is different, ZA targets the level of payout percentages for surrenders such that at least 90% of payouts fall between 80% and 130% of unsmoothed asset share. Whether we are meeting our target is normally reassessed twice a year and is determined by comparing the unsmoothed asset share of each surrendering policy to its surrender value. In practice it may not be possible to achieve payouts that meet this target as a percentage of asset shares at all times for reasons such as those referred to in Section 4.2.1.2. The calculation of surrender values is managed by the Company using a formula approach.

The surrender value bases for CWP Life policies are reviewed regularly to ensure that they are consistent with the above objectives. Reviews are undertaken at each bonus declaration.

Surrender values are not guaranteed.

4.2.2.2 *Surrender values close to maturity*

For surrenders close to the maturity date on CWP policies, the Company may grade the surrender value towards the then current maturity value for policies of similar type and similar duration in force.

When this is done, it is achieved through the use of appropriate parameters in the surrender value formulae described above.

4.2.3 *Surrender values on UWP policies*

4.2.3.1 *Surrender value calculation*

Surrender values for UWP policies are determined as the nominal value of the with-profits units at the quoted bid price, increased by any terminal bonus or reduced by any MVR that may apply at the date of surrender. On some policy types, a further surrender charge or reduction may also apply on surrender at various points in the policy term in accordance with the policy conditions. As noted elsewhere, at certain points in the lifetime of some policy types (referred to as Guarantee Dates) the Company has guaranteed not to apply a MVR, and this is reflected in the surrender values on the relevant dates.

The Company aims to set terminal bonuses or MVRs such that the target surrender payout is a percentage of asset shares. We are currently targeting an average of 100% of asset share. There may be some policies where the guaranteed minimum payout exceeds the underlying asset share. For policies where this is not the case ZA targets the level of payout percentages for surrenders such that at least 90% of payouts fall between 80% and 130% of unsmoothed asset share.

Whether we are meeting our target is normally reassessed twice a year and is determined by comparing the unsmoothed asset share of each surrendering policy to its surrender value. The levels of terminal bonus and MVR which apply from time to time are determined based on an investigation of policies within each product and UWP unit series. Aggregate asset shares and surrender values are compared for the policies in each product and unit series in order to determine appropriate terminal bonus or MVR scales.

Other than as described below, ZA does not guarantee to pay any minimum surrender value on UWP policies, and terminal bonus and MVR levels can be varied at the Company's discretion.

As noted above, a different approach applies to policies linked to Series 1 UWP units. These are described at the end of this Section.

4.2.3.2 Surrender values close to non-MVR dates

ZA does not adjust surrender payouts on UWP policies near to non-MVR Guarantee Dates to take account of the amount that would be paid on the date the guarantee applies. This means that in conditions where a MVR is being applied, the surrender value before and after a Guarantee Date could be significantly different from that at the Guarantee Date.

4.2.4 Factors influencing surrender values

The main factors influencing surrender values are similar to those which affect maturity payout levels, i.e. the level of available assets in the 90:10 Fund, the degree of smoothing being applied and the level of underlying guarantees. Although under normal circumstances ZA will aim to ensure that surrender values and maturity values move in a similar manner, it should be remembered that surrender values are not guaranteed. ZA may make substantial changes in surrender values from time to time, at its discretion, having regard to the need to take account of the interests of continuing policyholders in the 90:10 Fund. The extent to which the Company changes surrender values may also depend on the volume of surrenders from time to time, in order to protect the 90:10 Fund from any unusual or adverse levels of surrender activity.

Terminal bonuses and, for UWP policies, MVRs on surrender are kept under regular review, and the scales may change several times a year in response to changing market conditions.

4.2.5 Amounts payable on death claims

The amounts payable on death claims (as well as on certain other claims such as critical illness benefits, which occur on diagnosis of a defined serious illness) depend on the contractual terms of each policy type, as defined in the policy conditions. Typically, such

benefits will be determined using one or more of the following methods (in some cases taking the highest of the values arising under each method):

- The basic sum assured and accrued reversionary bonuses on CWP policies, or a given multiple of the bid value of the with-profits units on UWP policies. In each case, the benefit may be increased by an interim and/or terminal bonus based on the bonus scale in force at the time for similar policies reaching their maturity date. On UWP policies, no MVR will be applied on death or similar claims.
- A formula based on a return of premiums paid, possibly accumulated at a given interest rate (which depends on the policy type and may be zero). This method is commonly used for CWP pensions contracts.
- A guaranteed minimum amount, which may exceed the sum of the basic sum assured, accrued reversionary bonuses and any terminal bonus applicable at the time.

For some pensions policies (in particular, group pensions), there may be no benefit payable on death.

Some policies also have additional or optional benefits such as accidental death cover, waiver of premium benefit, etc. Claim amounts on such benefits will be as defined in the policy conditions.

4.2.6 Policies linked to Series 1 UWP units

An exception to the above description of maturity values and surrender values for UWP policies applies in respect of policies linked to Series 1 UWP units.

Under Series 1 UWP units, there are three unit prices, the offer price, bid price and guarantee price. Units are allocated at the offer price and, except on certain Guarantee Dates, cancelled at the bid price. On the Guarantee Dates (such as at the contractual maturity date or on a death claim) units are cancelled at the higher of the bid price and the guarantee price. On other dates units are cancelled at the bid price. The offer price and bid price respond actively to movements in the value of the underlying assets on a daily basis, and therefore less smoothing applies than on other UWP unit series in the 90:10 Fund. The guarantee price when the Series 1 unit fund was originally launched was 75% of the initial offer price and is guaranteed to grow each year at no less than 35% of the yield at

the start of the calendar year on 2½% Consols, an undated UK Government loan stock. In 2003, the bid price fell to close to the guarantee price, but did not fall below it.

To the extent that any payouts at the bid price exceed the value at the guarantee price, this excess is treated in the 90:10 Fund as if it were a terminal bonus, and a shareholder transfer of 10% of the excess is generated. Similarly, any increase in the guarantee price exceeding the guaranteed minimum increase is treated in the 90:10 Fund as annual bonus, and a shareholder transfer of 10% of the excess is generated. If the bid price should fall below the guarantee price, payouts will be based on the value of units calculated at the bid price, except for payouts on a Guarantee Date which will be based on the guarantee price.

No MVR or explicit terminal bonus can be applied to policies linked to Series 1 UWP units.

4.2.7 Documentation of methodology and assumptions

ZA 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.

5. BONUS POLICY

5.1 Principles

- (1) Bonus rates will be determined by the Board, having regard to the advice of the With-Profits Actuary.
- (2) All bonus rates will be reviewed regularly by the Company and revised when appropriate. A formal declaration of bonus rates will be made at least once in each calendar year.
- (3) Different reversionary, interim, annual and terminal bonus 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) Reversionary, interim and annual bonus rates for different bonus series and fund series will be set such that they move on a path towards the levels which the Company believes to be sustainable in the medium to long term, consistent with the sound and prudent management of the 90:10 Fund 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 reversionary and annual bonus rates from year to year, there are no constraints on the level of change in bonus rates and large changes may apply in unusual or adverse circumstances. Reversionary and annual bonus rates may be zero.
- (5) Terminal bonus rates will reflect the excess, if any, of the target level of payouts over any then current guaranteed minimum values. The operation of the bonus system and the smoothing of payouts, together with the need to meet the guarantees inherent in the 90:10 Fund, mean that bonuses will not necessarily reflect the entire effect of the investment performance of the Fund. In addition, terminal bonus rates may be zero, perhaps for sustained periods.

5.2 Practice

5.2.1 Bonus series

Within the 90:10 Fund, CWP business is classified into separate bonus series, reflecting the origins of the business and the policy type. For each bonus series, bonus rates are

declared which apply to all policies within that series. The different bonus series reflect variations in the underlying policy types, such as the tax treatment, the form of benefits paid and the nature of the guarantees attaching to the policy.

UWP business is categorised into a number of unit series, depending on the policy type and when it was written. Different annual bonus rates may apply to different unit series, for example to reflect different types of contract structure or to reflect the different tax treatment of life and pension contracts.

For a summary of the practices relating to overseas-type business and Eagle/Midland policies, please refer to Appendices D or E respectively.

5.2.2 Reversionary and annual bonus rates

Reversionary and annual bonus additions increase the level of guaranteed amounts payable on claims relating to certain events (such as on death, or at the contractual maturity or retirement date) that are defined in the policy conditions. Reversionary and annual bonuses are not guaranteed in advance, but once added they become part of the guaranteed benefits and cannot be taken away provided the policy continues without amendment to death, its maturity or the selected pension date.

On CWP policies, reversionary bonuses are declared as a percentage of the guaranteed amount and any previously added reversionary bonuses. In the case of deferred annuity policies, reversionary bonuses are applied as a percentage of the paid-up pension secured. The rate of reversionary bonus usually differs for different policy types, and the rate applied to the guaranteed amount may be different from the rate applied to attaching reversionary bonuses. Reversionary bonuses may be zero in any year. If they apply, reversionary bonuses are added at the end of a calendar year (or, in the case of group deferred annuity contracts, on the following scheme anniversary). Interim bonuses may be applied on claims arising between declarations of reversionary bonuses to reflect some or all of the potential reversionary bonus accrual in the interim period, but these are not guaranteed.

On UWP policies, annual bonuses are declared in the form of daily increases in the price of with-profits units. The rate of increase is declared in advance, usually on an annual basis (although it can be changed more frequently). For most series of with-profits units, there is a guaranteed minimum bonus rate (which may be zero, i.e. the unit price cannot

fall) and the bonus declared reflects the rate of increase over and above the minimum rate – both the minimum rate and the bonus rate vary by unit series. The exception is Series 1 units, where the guaranteed minimum bonus rate applies to the guaranteed unit price rather than the bid price.

5.2.2.1 General approach to determining bonus rates

ZA's general objective is to develop reversionary and annual bonus rates which move towards the levels which it believes to be sustainable in the medium to long term. In making this assessment, the Company takes account of trends in recent economic experience and the expected future investment return on the assets notionally allocated to each of the policy groups in the 90:10 Fund.

As part of the process for determining the rates of reversionary and annual bonus, ZA considers the current and projected financial position of the 90:10 Fund 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 bonus rates is established. Based on these investigations, reversionary and annual bonus rates are set at cautious, affordable levels. If the eventual outcome is such that a higher level of bonus could have been paid, any excess is available to be used towards terminal bonus or to support the Estate. Similarly, at times the Company may apply part of the Estate to provide temporary support to bonus levels if the eventual outcome is less than expected. The Company does not apply any specific rules relating the levels of reversionary bonus 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. On some policy types, the value of guaranteed benefits is currently considerably in excess of the aggregate asset shares - in such cases, no terminal bonus is payable, and current and future reversionary or annual bonus rates may be set at a low or zero level.

5.2.2.2 Frequency of review of rates

Reversionary bonus rates for CWP policies are reviewed annually. Interim bonus rates will be reviewed at least annually, and may be changed (including being set to zero) at any time.

Annual bonus rates for UWP policies are normally reviewed once a year, but ZA may review these rates more frequently (in which case it undertakes to inform policyholders of any change as soon as practicable thereafter).

5.2.2.3 *Changes in rates from year to year*

Under normal circumstances, ZA aims to change typical rates of reversionary or annual bonus declared from one year to the next on UK-type business by not more than 1.5%. However, in extreme adverse conditions, such as those which applied over 2002 and in 2003, larger changes may need to be applied, and reversionary and annual bonuses 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.

5.2.2.4 *Reversionary and annual bonus scales*

Although the Company aims to keep the number of different reversionary and annual bonus 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 (which as noted elsewhere in this PPFM document may vary for different groups of policies. For example, its different for UK-type and overseas-type policies and Eagle/Midland Unit Policies);
- any guaranteed levels of unit growth; and
- the current balance between asset shares and the value of guaranteed benefits.

ZA may create new UWP bonus series to maintain equity between different groups.

On Series 2 and Series 7 UWP units, there are minimum unit growth rates of 3% p.a. on life policies and 4% p.a. on pensions policies. On Series 2a and 2b UWP units, the minimum growth rates are ¾% on life policies and 1% on pensions policies. On the other series of UWP units (with the exception of Series 1 units), the minimum growth rates are zero. The annual bonus rates declared on these different unit series represent growth in

excess of the minimum unit growth rate. Different rates for different unit series will normally be declared which take into account the underlying minimum growth rates, but in either case it is possible that bonuses could be zero such that only the minimum unit growth rate applies.

5.2.3 *Interim bonus rates*

When claims arise on CWP policies between bonus declaration dates, ZA may increase the claim value by the addition of an interim bonus. Interim bonus rates are declared at each bonus declaration and are commonly, but not always, set equal to the reversionary bonus rate declared at that time for a given bonus series. Where the Company has determined that it may need to change future bonus rates, some or all of this change may be reflected in the interim bonus rates declared.

Interim bonus rates are not guaranteed and can be changed at any time.

5.2.4 *Terminal bonus rates*

5.2.4.1 *Terminal bonuses*

Terminal bonuses may be added to the amounts paid out when a claim arises. Terminal bonuses are a means of allowing for the actual experience of different groups of policies in the 90:10 Fund (including investment performance) over the lifetime of the policy up to the time of the claim, to the extent that this has not already been included in reversionary or annual bonuses and subject to a degree of smoothing.

Terminal bonuses are determined at the time of the claim based on tabulated scales which are reviewed regularly. As the amount available to pay terminal bonuses will depend on market conditions at the time, terminal bonuses are not guaranteed, and they may be varied frequently or removed altogether. As a result the Company does not expect to introduce terminal bonuses for the foreseeable future for most policies where no terminal bonus is currently paid.

Where they apply, terminal bonuses are expressed for most CWP policies as a percentage of the total reversionary and interim bonus added up to the date of the claim, although for some CWP group deferred annuity contracts terminal bonuses would be expressed as an addition to the total maturity benefits. The rate of terminal bonus applicable to a claim will depend on the policy type, and typically will vary according to the calendar year in

which the policy, or any premium increment, became eligible to participate in the profits of the 90:10 Fund or the period since the policy, or premium increment, first became eligible to participate in the profits of the Fund.

UWP policies generally become eligible for terminal bonuses once with-profits units have been continuously held for specified periods. Under circumstances where terminal bonuses apply, they will typically be expressed as a percentage of the nominal value of the units allocated to a policy at the date of the claim. Specific rates of terminal bonus may apply to different policy types. Within each unit series for each product the same rate of terminal bonus applies. For this reason ZA may create new UWP bonus series to maintain equity between units purchased at different times.

5.2.4.2 Determination of terminal bonus rates

Terminal bonus rates payable on both CWP and UWP policies are generally reviewed in detail on an annual basis once any proposed changes to reversionary, annual and interim bonus rates have been determined. However, terminal bonus rates may be changed at any time to reflect the prevailing investment conditions.

Terminal bonus rates are determined by considering current or projected asset shares on what the Company considers to be a realistic basis, taking account of the target payouts as a percentage of asset shares and any underlying guaranteed amounts (as increased by reversionary, annual and interim bonuses). The results of these projections are considered across groups of similar products and policies to derive an unadjusted terminal bonus scale, to which smoothing is applied. The amount of smoothing that can be applied at various times depends on a number of factors, as described in Section 6. Under normal circumstances the Company aims to set terminal bonus scales such that the amount by which maturity payouts on identical representative policies would change in successive years is in the range plus or minus 15%. However, larger differences may apply in periods of very adverse investment performance or when the financial circumstances of the 90:10 Fund are otherwise weak. In addition, the change in terminal bonus rates on single premium policies may be larger than on regular premium policies, as the impact of different investment returns according to the period since the single premium was paid will generally be greater. There may be some individual policies that change by more than 15% between successive years. On average however, the maturity payouts for individual policies are aimed to vary by less than this percentage in successive years.

The target for setting terminal bonuses on Section 32 Esitran policies is described in section 4.2.1.2.

In making these decisions on terminal bonus rates, discretion is exercised by the Board, having regard to the advice of the With-Profits Actuary and taking into account the target levels of payouts described in Section 4.

5.2.4.3 Market value reductions

In general terms, a MVR may be applied when the value of the assets supporting with-profits units falls below the nominal value of the units. The objective in applying a MVR is to ensure that payouts are in line with the target percentage of the asset shares in order to protect the interests of continuing policyholders in the Fund. The rate of any MVR applying from time to time can be varied frequently by the Company. The rate may be different for different policy types and unit series, and can vary according to the period over which the policy, or premium increment, has been invested in the 90:10 Fund. A MVR will not be applied if its value is less than £10 or less than 0.5% of the nominal unit value. For partial withdrawals the £10 threshold is reduced prorata by the amount withdrawn compared to the nominal unit value of the policy before that withdrawal. For plans that are made up of individual policies the £10 threshold applies over the total value of all of those policies held.

On some policy types, the Company guarantees that no MVR will be applied in certain circumstances or on certain dates, such as on a given policy anniversary, on death or at maturity, or (for some single-premium bonds) on partial withdrawals up to a certain amount. In this document, we have used the term “Guarantee Date” to refer to any date or event on which a MVR will not be applied.

5.2.4.4 Terminal bonuses and MVRs

It is possible that a terminal bonus could apply on some policies when a MVR applies on others.

5.2.4.5 Series 1 UWP units

On Series 1 UWP units, there are no explicit terminal bonuses and no MVR can be applied, as described in Section 4.

5.2.5 *Approximations used in determining bonus rates*

As described earlier, a number of approximations are used in determining bonus rates. The most significant approximations arise in the projections ZA uses to assess sustainable bonus rates, where the future experience assumptions used in the projections are estimates.

For determining the bonus rates declared each policy is assigned into a group determined by its product type, unit series, year of entry and policy term.

The Company's estimates of future experience in respect of expenses, surrender rates, mortality and tax, etc, will be based on analyses of its recent experience in these areas, taking appropriate account of any known factors which are likely to change the position going forward. The estimates of future investment returns will be based on the Company's view of investment markets at the time and take into account the investment strategies expected to apply to various groups of policies.

For some policy types, where full histories of information on premiums paid are not readily available, approximations are used. The less variation there has been in the level of premiums, the easier it is generally to derive bonus rates which reflect the actual contributions of different policies to the 90:10 Fund. On most regular premium life policies, where such variations relate mainly to reviews on mortgage-related endowments, the degree of approximation is relatively small and it is possible to model most of the business for the purposes of setting bonus rates. For some classes of pensions business, on the other hand, there may be considerable variation in the level of premiums paid over the years. Therefore the degree of approximation is higher and a lower proportion of business is used for setting bonus rates.

6. SMOOTHING

6.1 Principles

- (1) Subject always to the overriding constraint of maintaining the adequacy of the financial resources of the 90:10 Fund so that they are sufficient to meet the payment of guaranteed benefits as they fall due, smoothing will be applied to payouts through operation of the bonus mechanism.
- (2) In exceptional 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.
- (3) The degree of smoothing on surrenders may be less than that on maturities and other types of claim, and that on single premium policies may be less than on regular premium policies.

6.2 Practices

6.2.1 Smoothing

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

ZA applies smoothing by means of the bonus mechanism, including, in normal circumstances, changing reversionary, interim, annual and terminal bonuses levels at least annually, limiting the changes from year to year in bonus levels and setting bonus scales which apply to groups of policies rather than individual policies.

For a summary of the practices relating to overseas-type business and Eagle/Midland policies, please refer to Appendices D or E respectively.

6.2.2 Types of smoothing

The main types of smoothing can be summarised as follows. ZA 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 90:10 Fund. A lesser degree of smoothing is likely to be applied in adverse or exceptional circumstances.

6.2.2.1 Smoothing within groups of policies

The same bonus 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. As a consequence, the actual payout will not be exactly the same as the target percentage of asset share for all policies within the group, but rather the target will reflect the average characteristics of the group as a whole.

6.2.2.2 Smoothing across groups of policies

Crude bonus rates will be set for groups of policies with similar characteristics as described above. Similar calculations will be carried out to determine the crude bonus 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 bonus rates accordingly in arriving at a final bonus scale. For example, the Company may consider groups of policies with similar durations in force maturing in a given year when determining bonus rates.

6.2.2.3 Smoothing where there are guarantees

For policies within the same bonus series, smoothing of bonuses will be applied in the same way regardless of whether a policy has a guarantee.

6.2.2.4 Smoothing from period to period

Asset shares will largely reflect investment conditions from time to time, but the Company aims to manage payouts such that the difference in the maturity values of similar policies maturing in successive years is within a given range, as described in Section 6.2.3. As a result, payout levels may, from time to time, depart from the target percentages of asset shares described in Section 4. In this case, the Company aims to smooth average payouts back into line with the target level of asset shares over a small number of years, along what it refers to as a “glidepath”. The glidepath is not fixed, but will be adjusted from year to year in response to actual experience, in particular to

investment performance. To the extent that applying the glidepath results in a profit or loss in the 90:10 Fund, this will be reflected in the Estate and be taken into account when considering changes in the target percentage of asset shares paid out on claims in the future.

6.2.2.5 *Smoothing of reversionary and annual bonus rates*

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

6.2.3 *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 90:10 Fund notionally allocated to that group of policies; and
- the change in the ratio of asset shares to payouts over the period.

In normal circumstances, ZA's general aim for maturity claims and death claims (as well as for surrender claims on CWP pensions policies close to the maturity date) is to smooth payouts such that the difference in successive years in the value of payouts on similar policies is not more than plus or minus 15%. As described elsewhere, this applies for groups of policies as a whole, and there can be greater variation at the level of individual policies. In addition, the range is likely to be larger for single premium policies than regular premium policies as the impact of different investment returns according to the period since the single premium was paid will generally be greater.

In adverse circumstances, a wider range may be applied. For example, typical changes in payouts were in the range 15% - 20% in successive years over the period from 2000 to

2002 as a result of the substantial falls in asset values over that period. Even larger year-on-year changes could be (and have been) applied in exceptional conditions.

6.2.4 Limits on smoothing

As noted above, the ability of the Company to apply smoothing depends on the available financial resources of the 90:10 Fund. Smoothing may be limited in adverse economic conditions so as not to put the overall financial condition of the 90:10 Fund at risk.

Smoothing may also be limited in circumstances where guaranteed payouts have become substantially greater than the target percentages of asset shares described in Section 4. For example, in 2003 the value of the guaranteed benefits on some pensions policies exceeded the underlying asset shares by a considerable amount, in large part as a result of substantial falls in the value of the underlying assets in the preceding period. Under such circumstances, ZA believes it is not appropriate to apply smoothing to payouts on such policies, as to do so could adversely affect the financial condition of the 90:10 Fund and unfairly damage the prospects for other groups of policyholders. It therefore reduced the value of payouts for such policies to, or near to, the minimum guaranteed amounts relatively quickly.

As the fund is closed to new business and will reduce in size over time it may be necessary to change bonus rates more than once a year.

6.2.5 Differences in smoothing by policy type and claim type

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 also varies 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. As noted in Section 4.2.6, a lesser degree of smoothing is applied in respect of Series 1 UWP units, due to the pricing structure of those units.

For surrenders on CWP business, claims closer to maturity may be smoothed more than claims occurring earlier in the policy term.

6.2.6 *Partial withdrawals where no MVR is applied*

Some with-profits contracts have a facility where regular partial withdrawals, up to a limit determined from time to time by the Company, may be taken without a MVR being applied. This MVR is not recouped from future payments from the policy.

7. INVESTMENT STRATEGY

7.1 Principles

- (1) Investment policy for the 90:10 Fund is the responsibility of the Asset / Liability Management Investment Committee (ALMIC), subject to the powers reserved by the ZA Board in respect of setting of investment strategy and approval of With-Profits fund strategies, taking account of advice from the Investment Managers, the Chief Financial Officer (“CFO”), the Head of the Actuarial Function and the With-Profits Actuary. The ALMIC will refer any major proposals in relation to investment strategy to the Board for approval.
- (2) The investment strategy of the 90:10 Fund 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, including derivatives, 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 ALMIC and followed, so far as is reasonably practicable, by the Investment Managers.
- (4) Subject to policyholders being given advance notice and to ZA fulfilling all appropriate legal and regulatory requirements, certain assets may be notionally allocated to different sub-groups of policies within the 90:10 Fund where the ALMIC 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.

7.2 Practice

7.2.1 Investment objectives

Most of the assets of the 90:10 Fund are currently managed by Threadneedle Asset Management Limited, a former member of the Zurich Financial Services group. A small portfolio of assets is managed by Gresham Fund Managers, and some assets backing overseas-type business are managed locally in the relevant territory.

The current overall investment objective is to achieve above average returns in the longer term relative to market-index benchmarks agreed between the ALMIC and the Investment Managers. These benchmarks will make appropriate allowance for risk preferences, as determined by the ALMIC having regard to the characteristics of the business in the 90:10 Fund such as the level of guarantees and the average outstanding term in force.

The Investment Managers may be instructed to apply different asset types in respect of any identified sub-groups of business within the 90:10 Fund. The asset types that may be used include equity-type assets, such as UK and overseas shares (either directly or via collective investment schemes) and property, and fixed interest type assets, such as government bonds and corporate bonds, as well as unlisted assets and cash. The 90:10 Fund may also make use from time to time of appropriate derivatives, as described below.

The investment mix for the assets notionally allocated to each separately identified sub-group of policies will have regard to the maturity of the 90:10 Fund 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. In general, a higher proportion of fixed interest assets and a commensurately lower proportion of equity-type assets will be notionally allocated to groups of policies with relatively high levels of guarantees and/or a short outstanding duration to the next point at which a guarantee applies. An appropriate degree of liquidity will be maintained for each notional pool of assets, reflecting the characteristics of the associated policies.

For a summary of the practices relating to overseas-type business and Eagle/Midland policies, please refer to Appendices D or E respectively.

7.2.2 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 ALMIC and the Investment Managers in order to monitor progress in respect of investment policy and to consider any appropriate changes.

7.2.3 Matching of assets and liabilities

ZA operates a matching strategy for the assets within the 90:10 Fund whereby certain assets are selected whose values broadly move in line with the values of some of the underlying liabilities of the fund in response to changes in investment conditions. The liabilities include claims on maturity, death and surrender. The guaranteed benefits for these claims are typically matched by fixed interest assets.

Where the asset mix allows, matching assets are chosen to ensure that they provide appropriate patterns of income from interest and capital proceeds to meet the guaranteed benefit payments.

Other assets may be invested to include equity-type assets with the aim of achieving a higher investment return consistent with the principles set out above.

Liabilities in respect of guaranteed annuity rates are matched by fixed interest investments and an associated derivative hedging programme.

7.2.4 Investment in different asset classes

Based on the mix of guaranteed and non-guaranteed liabilities in the 90:10 Fund, the nature of the underlying policies (in particular, the extent to which policyholder benefits depend on certain levels of investment performance) and the overall investment strategy, ZA sets benchmarks for the investment mixes of the assets backing policies within the Fund. The benchmarks also specify, in broad terms, the mix between short-term, medium-term and long-term fixed interest investments. Different benchmarks will apply for UK-type and overseas-type business.

The benchmarks for UK-type business are currently set by considering the level of guarantees and the average outstanding term to the next guarantee date for different policy groups within the Fund. These benchmarks are reviewed periodically in response to substantial changes in investment conditions. The Investment Managers are required to manage the assets within the specific limits defined by these benchmarks. Benchmarks for overseas-type business are reviewed similarly.

The Investment Managers are also required to hold an appropriate range of investments within each asset class, for reasons of security and diversification. The Investment Managers will normally only invest in assets of a quality consistent with the benchmarks. The current criteria for UK business are that investment is only allowed in individual bonds with a Standard & Poors credit rating of at least BBB, and that the overall average Standard & Poors credit rating for the fixed interest assets should be at least AA minus. However, ZA may continue to hold investments in the 90:10 Fund whose security ratings have fallen to some extent in order to avoid crystallising losses unnecessarily. Furthermore, the ALMIC may change the above rating criteria if it believes that to do so would be in the interests of policyholders in the 90:10 Fund.

The investment benchmarks include specific criteria for liquidity. In practice, the assets in the 90:10 Fund as a whole include a substantial amount of fixed interest securities, including government bonds, which are intended to provide liquidity to meet surrenders and contractual liabilities as they fall due. Therefore, the Company believes that the liquidity criteria are comfortably met.

Investment Managers may be permitted to seek additional yield on government securities through their sale and repurchase and through investing the proceeds in other assets including variable-rate asset-backed securities. When used, this activity is restricted to only a proportion of the government securities held and is subject to credit and diversification constraints.

7.2.5 Asset mix

In the past, ZA has invested a significant part of the assets of the 90:10 Fund in equities and property with the aim of achieving above average returns over the long term compared to the return on fixed interest securities. However, it is not always appropriate to hold a significant proportion of equities and property, owing to their volatility, the

prevailing market conditions at different points in time, the fact that the 90:10 Fund is closed to new business with groups of policies approaching their maturity dates or other Guarantee Dates, the need to protect the financial condition of the 90:10 Fund and the need to hold appropriate statutory reserves.

From 30 June 2009, separate asset mixes may be used for identified groups of policies to reflect the level of guarantees and the average outstanding term to the next guarantee date. The assets notionally allocated to a group of policies may consist of a mix of equity type assets, property, fixed and variable interest type assets, and cash. The investment return credited to each group of policies will be determined by the assets notionally attributed to it.

In general, a higher proportion of fixed and variable interest type assets and hence a lower proportion of property and equity type assets may be notionally allocated to groups of policies with relatively high levels of guarantees and / or a short average outstanding duration to the next guarantee date. For some policy groups where the current value of their guaranteed benefits exceed their asset shares, we invest entirely in fixed and variable interest type investments. We allocate part of the Estate to these groups to compensate for the possibility that future long term returns might then be less than the returns would have been had investment in equity and property type investments been retained. The allocation is made by making an annual percentage addition to asset shares. This results in an increase to the claims paid for policy groups whose enhanced asset shares at the date of claim exceed their guaranteed benefits. The current excess of the value of guaranteed benefits over asset shares means this is only likely for policy groups with long outstanding terms until the date of claim. The percentage allocation rate is set at the time the investment strategy is determined and does not depend on the actual returns achieved.

Provided the ALMIC deems it desirable and the Company judges it to be possible, ZA will aim to avoid abrupt changes in the investment mix, but nevertheless it may elect to move quickly into appropriate fixed interest investments in response to adverse market movements, or to protect the financial condition of the Fund.

ZA updates policyholders about the asset mix at least annually.

7.2.6 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 ALMIC.

7.2.7 Non-tradable assets

The 90:10 Fund does 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 ALMIC.

ZA itself has a number of subsidiary companies. These form part of the assets of the NP Fund and the SH Fund, and the 90:10 Fund therefore has no interest in any profits (or losses) from those companies.

7.2.8 Use of derivatives

The ALMIC may from time to time instruct the Investment Managers to consider the use of derivatives. Derivatives may be used, for example, as part of efficient portfolio management to effect switches between equity-type and fixed interest-type assets, to provide some protection to asset shares against adverse market movements or provide a lower-risk opportunity to benefit from positive market movements.

Derivative cover may also be purchased within the Estate to protect it against changes in investment conditions. The Estate is sensitive to changes in the cost of providing policyholder guarantees which depends on the performance of the assets notionally allocated to policy groups in the Fund.

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.

The current criteria for use of derivatives are that the counterparties to derivative contracts must provide appropriate security and must be approved counterparties as defined under FSA Rules and Guidance, and that any such contracts entered into by the

Company must be admissible under FSA Rules and Guidance at the time that the contract is entered into. The Company may continue to hold derivatives even if these criteria are subsequently not met. Changes to the criteria may be agreed by the ALMIC if it believes that to do so would be in the interests of policyholders in the 90:10 Fund.

The fund may hold derivatives to protect it against falling equity values. This may be achieved by buying 'put options' and selling 'call options' at the same time. This strategy may have an initial cost depending on the strike prices chosen for the put and call options. The higher the strike price for the call option, the higher the initial cost but also the higher the potential investment return from equities held. This combination of a put and call option sells the upside above a given level (the strike price of the call option) in exchange for providing protection below another level (the strike price of the put option). The fund is therefore protected if equity markets fall by holding put options but the potential growth, if equity prices rise significantly, is limited by issuing call options.

The fund may also buy put options without selling call options at the same time. This strategy always has an initial cost, but, apart from this, does not limit the potential return from equities held in a rising stock market.

The option strategy adopted will be determined each year based on prevailing market conditions and investment advice received. Both strategies reduce the volatility of equity returns.

We will update policyholders on these holdings at least annually.

8. EXPOSURE TO BUSINESS RISK

8.1 Principles

- (1) The Board will aim to manage risks in relation to the business of the Company and the 90:10 Fund through regular monitoring of risks and by promptly taking appropriate actions to reduce inappropriate risk exposure.
- (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 90:10 Fund. In particular, the Fund is closed to all new business except for contractual increments to existing policies in the Fund.

8.2 Practice

8.2.1 Risk management structure

Risk management is one of the key responsibilities of the Board. The Board manages risk through its planning and operational strategies, and by collection and use of appropriate management information.

Day-to-day management of the major risk factors affecting the business is the responsibility of the different business units of the Company. The business units are also responsible for identifying any new risks which emerge and which may become significant.

A Risk Committee of the Board has been established to monitor the risk management processes of the Company and advise the Board accordingly. The Risk Committee is required to report to the Board at least quarterly, although this may be more frequently if required.

Techniques used to manage risk include changes in investment strategy, use of reinsurance or use of derivatives to provide appropriate hedging, and securing the services of suitably qualified resources to manage the business (including, if the Board deems it appropriate, through the outsourcing of administrative or technical work to third parties).

8.2.2 Major risks

The most significant of the business risks that have been identified as being relevant for the business of the 90:10 Fund at the time of writing this PPFM are set out below, along with the actions that have been taken to mitigate these risks. As the business in the 90:10 Fund matures and as the external environment changes, different risks may be identified in the future or the risks described may reduce in importance. Each of the risks described can influence the amount and timing of the surplus that emerges in the 90:10 Fund. As stated elsewhere in this document, the maintenance of adequate financial resources within the 90:10 Fund is considered paramount, and appropriate action will be taken to minimise the potential impact of these risks.

The risk factors set out below are listed in no particular order.

8.2.2.1 Longevity risks and guaranteed annuity options

Much of ZA's pensions business includes options to take benefits as an annuity at maturity. Some CWP pensions policies include a contractual guarantee of a minimum annuity rate. These guarantees impose inherent risks on the 90:10 Fund in that the cost of the guarantees increases with improvements in longevity of annuitants and with reductions in interest rates.

ZA has set up explicit reserves to allow for the cost of these guarantees, and it regularly monitors these reserves and the associated mortality assumptions and reviews the investment strategy in order to limit the exposure to changes in market conditions.

8.2.2.2 Other guarantees associated with with-profits policies

Contractual guarantees apply to most CWP and UWP policies in the 90:10 Fund. They include guaranteed minimum amounts on payouts on maturity and death, as well as on surrender on certain defined events (such as Guarantee Dates when no MVR can be applied on UWP policies).

As reversionary and annual bonus additions are applied, the underlying level of these guarantees increases. ZA manages this by limiting the build up of these guarantees, for example by applying reversionary and annual bonus rates over time at rates which it considers can be adequately supported by the financial resources of the 90:10 Fund.

8.2.2.3 Investment risks

There are a number of types of investment risk – for example the most relevant for the business of the 90:10 Fund are likely to be falls in equity/property values, changes in fixed interest yields, defaults on fixed interest and variable rate securities, and liquidity constraints on variable rate asset backed securities. ZA attempts to manage these risks through the investment strategies it adopts for different groups of policies, as described in Section 7, including matching liabilities with fixed interest assets of appropriate term, investing only in corporate bonds of appropriate quality, managing the balance between the Fund's exposure to equities and property and investment in fixed interest assets in a manner which it considers appropriate to support the levels of guaranteed benefits in the business, and by maintaining sufficient levels of alternative liquid assets.

The asset mix may be set separately for identified groups of policies to reflect their level of guarantees and the average outstanding term to the next guarantee date. In general, to manage investment risk and protect the security of policyholder benefits, a higher proportion of fixed and variable interest type assets and hence a lower proportion of property and equity type assets may be notionally allocated to groups of policies with relatively high levels of guarantees and / or a short average outstanding duration to the next guarantee date.

Most of the investment management activities relating to the 90:10 Fund are carried out by the Company's professional Investment Managers, as described in Section 7. These activities are managed by formal agreements between the parties, supported by regular meetings and dialogue, and monitored regularly by the ALMIC.

8.2.2.4 Miscellaneous business risks affecting the with-profits business

Miscellaneous risks affecting the 90:10 Fund 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. A scheme of arrangement which came into effect on 1st January 2005 gave additional protection to the 90:10 fund. From 2005 onwards, we changed to charging a fixed amount each year, increasing in line with the Average Earnings Index, to cover servicing costs and administration costs associated with a claim. Investment fees will be charged as incurred. The costs charged in the first year will be lower than those incurred in 2003. Since 2010 when the National Average Earnings Index was abolished,

the inflation of costs charged to the fund has been based on Average Weekly Earnings Index. The way we charge and the amounts charged will be reviewed after 10 years.

Expenses for Group Pension Scheme plans and those incurred when setting up increases to existing plans are not affected by the scheme of arrangement and continue to be charged to the 90:10 Fund. We only allocate expenses to the 90:10 Fund which we consider to be fair and reasonable.

The other types of risk are largely outside the Company's control, but ZA has allocated explicit accountabilities to key staff to monitor and manage such risks.

8.2.2.5 Potential compensation claims in respect of allegations of misselling.

ZA 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 ZA associated with misselling of business in the 90:10 Fund, these will be met from the NP Fund.

8.2.3 Impact of risks on payouts

Generally, any adverse impacts of business risks are not applied directly to the calculation of individual policy asset shares, but instead the cost of risks is allocated to the 90:10 Fund as a whole. ZA believes this to be consistent with the fundamental concepts of with-profits business.

To the extent that the ability of ZA to provide payouts as described earlier in this PPFM document depends on the overall financial strength of the 90:10 Fund, 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 levels or possibly a reduction in the target ratio of payouts to asset shares. 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.

8.2.4 Impact of external risks

Risks arising in the 100:0 Fund, the DCP Fund or the NP Fund will not affect policies in the 90:10 Fund. An exception to this might arise in the event of extreme adverse investment conditions, such that the 90:10 Fund needed to call upon financial support from the DCP Fund or NP Fund (or both) at a point when, because of the impact of other risks, that Fund was unable to provide that support. In those circumstances, support would need to be provided from any available resources of the SH Fund. The means of providing support to the 90:10 Fund is described in Appendix C.

9. CHARGES AND EXPENSES

9.1 Principles

- (1) All charges for administration expenses and commission applied to asset shares in respect of policies in the 90:10 Fund will be based on what the Board of ZA, in consultation with the With-Profits Actuary, reasonably considers to be a fair apportionment of the costs incurred by the Company, including any spreading of development costs.
- (2) The cost of investment management applied to asset shares in respect of policies in the 90:10 Fund will be based on what the Board of ZA, in consultation with the With-Profits Actuary, reasonably considers to be a fair apportionment of the total investment management costs incurred by the Company, taking into account the actual asset mix and investment activity of the 90:10 Fund.
- (3) The Board of ZA may from time to time determine alternative strategies for the management of the business of the 90:10 Fund 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 90:10 Fund. The Board will take account of any factors it believes to be relevant when taking such decisions.

9.2 Practice

9.2.1 Types of charges

For policies in the 90:10 Fund, costs of administration and investment management are generally not applied as specific charges defined in the policy structures. Instead, these costs are deducted from the accumulating asset shares and therefore affect each policy's ultimate benefits to the extent that asset shares are used to calculate such benefits.

The costs of providing risk benefits, such as life cover and critical illness cover, are charged to asset shares based on the estimated average cost over groups of similar policies.

To date, the costs of certain other guaranteed benefits, such as guaranteed annuity options, guaranteed maturity values and guaranteed non-MVR options, have been met

from the resources of the 90:10 Fund as a whole. Similarly, the impact of smoothing has been met by the Fund as a whole. This has had an impact on the available financial resources that can be taken into account when determining payout levels for all policies in the 90:10 Fund using the approaches described in Section 4.

On some policy types, specific charges are built in to the product structure. For example, on some UWP policies there are explicit rates of allocation of UWP units and specific charges to allow for the costs of risk benefits, administration and investment management. The impact of these charges is to reduce the level of guaranteed benefits on the policies affected. The calculation of asset shares is maintained separately, and it is the asset share which informs the ultimate payouts (other than when the guaranteed benefits exceed the asset share result after smoothing).

9.2.2 Relationship between charges and actual expenses

ZA's objective is to allocate expenses to the 90:10 Fund using a fair estimate of the actual costs of administering the business of the Fund. The expenses allocated to the Fund are charged to asset shares using the methods set out in Appendix B. As a result of the scheme of arrangement effective 1st January 2005, administration expenses for Group business and all investment management fees will be charged to the fund as incurred. Administration expenses for all other business will be allocated to the fund on a fixed rate basis, increasing in line with the Average Weekly Earnings Index.

This arrangement protects the fund from increases which may result from the reducing portfolio. Although policyholders may be losing some of the possible upside benefits of efficiency improvements made by ZA, this is adequately compensated for by the removal of the exposure to the downside risk of escalating expenses, caused by the diseconomies of scale that can sometimes occur in a closed fund situation. The charges will be reviewed after 10 years. Certain unitised policies also have monthly fees deducted from units in accordance with plan conditions. These fees are reviewed annually and normally increase in line with the Average Weekly Earnings Index. Where investment is in both with-profits and unit linked funds, such fees are deducted in proportion to unit holdings.

9.2.3 Reviews of the charging basis and of outsourced services

As noted in Appendix B, ZA reviews the position with regard to charging expenses and other costs to asset shares regularly, and makes appropriate changes from time to time.

However, the Company does not expect to make significant changes to its approach in this regard except where necessary to correct any material error.

The Company has in place with its Investment Managers an agreement that governs the services provided by the Investment Managers. This agreement is for an initial period of 8 years from June 2003 and is subject to review at the end of that period. The agreement may be terminated at any time subject to 12 months notice, if termination is before the initial period expires, or 6 months notice after expiry of the initial period. It may also be terminated in other circumstances such as where there is a material breach of the agreement or where there is gross underperformance of the Fund compared to agreed investment criteria.

10. MANAGEMENT OF THE ESTATE

10.1 Principles

- (1) ZA's objective is to ensure a fair and orderly distribution of all the assets in the 90:10 Fund, including the Estate, if any, 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, in particular in respect of the 90:10 split of distributable surplus.
- (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 90:10 Fund 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.

10.2 Practice

10.2.1 The Estate

The Estate is the difference, if any, between the total value of the assets in the 90:10 Fund and the value of assets needed to support the current and future liabilities of the Fund. This is described further in the Glossary in Appendix A.

At the time of writing this PPFM, the Estate forms a relatively small part of the total assets of the 90:10 Fund. As ZA is targeting payouts as a percentage of asset shares (as described in earlier sections) and as the 90:10 Fund is closed to new business, the Company considers it unlikely that the Estate will grow substantially in proportion to the Fund as a whole. The relative size of the Estate will, however, change to some extent from time to time as a result of factors such as smoothing, miscellaneous profits or losses, etc.

10.2.2 Management of the Estate

As the 90:10 Fund is closed to new business, other than a small amount of incremental business, the financial resources within the Fund available to meet payouts are finite. One of ZA's objectives is to achieve an orderly run-off of these resources 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 90:10 Fund.

ZA manages this by periodically considering the current and projected future position of the assets and liabilities of the 90:10 Fund based on what it believes to be realistic assumptions for future experience. It does this by constructing a “realistic” balance sheet under which it compares the value of the assets with the value of the liabilities including an estimate of the underlying cost of guarantees modelled on a “market-consistent” basis. The market-consistent approach uses, where possible, the value of an exactly equivalent traded asset (including derivatives) to value a liability. Where this is not possible, liabilities are valued in such a way as to be consistent with the market value of traded assets at the valuation date. This can be interpreted as the amount of assets needed to fully hedge a given liability at the valuation date.

As described in earlier sections of this document, the key mechanisms for managing the financial resources of the 90:10 Fund, including the Estate, are the bonus policy and the smoothing policy, i.e. the discretionary elements that ZA can use to manage the level of payouts from time to time.

From 1 January 2009, the Estate will be distributed to customers using the terminal bonus or MVR mechanism by considering whether to include an enhancement within asset shares at the time of the claim. Any enhancement to asset shares will be expressed as a percentage addition to the asset share which will be reviewed at each bonus declaration. The enhancement could be altered or removed entirely at any time, depending on the experience of the fund. The enhancement will apply to the asset share of all UK-type policies claiming at a given time. If an enhancement is made to asset shares, claims payments may increase as a result of increased terminal bonus rates, reduced MVRs on UWP contracts or increased surrender values on CWP contracts. For the purposes of determining any distribution of the estate, ZA reserves the right to exclude any new investment into the fund that is made after 1 April 2009.

Essentially, 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 bonus distributions and any other appropriate adjustments) is approximately equal to the total financial

resources of the 90:10 Fund including the Estate. By adopting such an approach, ZA expects the Estate to run down to zero over time broadly in line with the run-off of the business after taking into account business risks faced by the Fund. To make allowance for the risks that the fund is still exposed to, the enhancement percentage of asset shares is likely to be lower than the percentage of total asset shares the estate represents.

10.2.3 Management of the 90:10 Fund in the future

All with-profits funds face the problem, as the business in force reaches maturity and the number of policies declines, of being progressively more difficult to manage in an equitable manner. For example, a with-profits fund depends on having a certain level of Estate in order to be able to apply smoothing, but it is more difficult to apply smoothing over the short term than the long term, and more difficult 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, when the assets of the 90:10 Fund reduce to such a size that the Board of ZA, having taken advice from the With-Profits Actuary, believes that it is no longer in the interests of policyholders to continue to manage the 90:10 Fund on a with-profits basis as described in this document, then the Board may elect to convert the then remaining policies in the 90:10 Fund to a basis that consolidates any bonuses ZA expects to pay into a fixed benefit. This would be subject to satisfying any relevant legal and regulatory requirements in operation at the time of the proposed conversion.

In this case, ZA would determine fixed bonus rates such that the available assets in the 90:10 Fund would be distributed to that business over the remaining life of the policies in force, based on reasonable assumptions determined by the With-Profits Actuary. The fixed bonus rates determined would 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 90:10 Fund would 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 would be reviewed and adjusted as considered appropriate.

10.2.4 *Investment strategy for the Estate*

The mix of assets in the Estate takes account of the mix of assets in the 90:10 Fund 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 90:10 Fund.

10.2.5 *Shareholder support*

Although the Company expects to be able to manage the 90:10 Fund including the Estate over time such that it will not require additional financial support, in adverse circumstances it may be necessary to call upon temporary or permanent financial support from the DCP Fund, NP Fund or SH Fund. The means for providing this support is described in Appendix C.

11. AMENDMENTS TO THE PPFM

11.1 Amendment to the Principles

The Board of ZA may amend the Principles set out in this document if they reasonably consider, having taken the advice of the With-Profits 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 90:10 Fund 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.

If the With-Profits Actuary believes any proposed amendment to the Principles will or may have a material adverse impact on the rights or reasonable expectations of any class or group of policyholders, he/she shall give notice of such proposed amendment to the Regulator and such amendment shall not take effect unless the Regulator has, before the expiration of the period of one month beginning with the date on which it received such notice, notified the Board of ZA that it does not object to the amendment, or that period has elapsed without the Regulator having served on ZA a written notice of objection. 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.

11.2 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 With-Profits 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 will 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 With-Profits 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 ZA.

Collectively, the group will be responsible for:

- (a) Determining and agreeing the details of the proposed changes;
- (b) Referring back to the ZA Board if issues cannot be resolved or if it is felt to be appropriate for the ZA Board to discuss and agree the finer details;
- (c) Ensuring that the Independent Person has sufficient time (normally 4 weeks) to consider and comment on material proposed changes to practices.

APPENDIX A – GLOSSARY

100:0 Fund	The Long Term Business Fund which relates to with-profits policies under which 100% of the investment return less charges and any taxation will be distributed, over time, to policyholders in the form of guaranteed benefits plus bonus additions.
90:10 Fund	The Long Term Business Fund which relates to with-profits policies under which any profits or losses arising are distributed 90% to policyholders (by way of bonus additions) and 10% to shareholders (by way of transfers out of the fund).
Actuarial Function	The function described in the Supervision Manual of the FSA Handbook , 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 bonus	A bonus which is added on a regular basis throughout the life of a unitised with-profits policy by increasing the price of the underlying with-profits units (except in the case of Series 1 Units where the annual bonus is added only to the guaranteed unit price)
asset share	A measure of the share of assets in a with-profits fund which is attributable to a with-profits policy , calculated by accumulating premiums paid at the rates of return earned on the assets notionally allocated to the policies, after allowing for charges such as expenses, mortality, distributions to shareholders and tax, and may include allowance for an enhancement as a result of the distribution of the Estate. Asset shares are described in more detail in Appendix B.
bonus	The means by which the policyholders' share in the profits arising in a with-profits fund are allocated to individual with-profits policies . Bonus levels are not guaranteed in advance. Bonuses are sometimes referred to as "dividends".
bonus series	In respect of conventional with-profits policies , a group of policies for which the same set of bonus rates is declared.

Call Option	A contract giving the right but not the obligation to buy an asset at a fixed price on a future date.
Company	Zurich Assurance Ltd
Conduct of Business Sourcebook	The part of the FSA Handbook of rules and guidance containing the detailed conduct of business requirements for firms regulated by the Financial Services Authority .
conventional with-profits policy	A with-profits policy which is not a unitised with-profits policy . Under a conventional with-profits policy, the amount payable to the policyholder is defined as a given lump sum or annuity payable on death or maturity assuming that all premiums are paid, together with any bonus additions that may apply.
Defined Charge Participating Fund	A Long Term Business Fund which does not include any with-profits policies but provides a transfer of surplus to the 100:0 with- profits fund.
Eliminated Deficit Assets	Assets at least equal in value to the amount of a Realistic Deficit which is eliminated by the application of the Realistic Support described in paragraph 3A, 3B or 3C(2) of Appendix C.
Estate	The assets in a with-profits fund held in excess of those required to back the expected liabilities of that fund, including payments of future bonuses and any liabilities which arise from the Company's regulatory duty to treat policyholders fairly.
Financial Services Authority (FSA)	The regulator for life insurance business and other insurance, savings and banking businesses in the UK.
FSA Handbook	The rules and guidance of the Financial Services Authority .
Future Volatility Cost	the excess of the current value of a liability in a Realistic Balance Sheet over the Intrinsic Cost
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 .
Guarantee Date	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 value reduction .

guaranteed rate of growth	In respect of with-profits units in a given unit series , the minimum annual rate at which the price of the units is guaranteed to increase (which on certain funds may be zero).
Independent Person	A person with appropriate skills and expertise who is independent of the Company who is asked by the Company to report on how it has complied with the Principles and Practices of Financial Management.
Individual Capital Guidance	Guidance given to the Company by the FSA pursuant to paragraph INSPRU 7.1.94G of the FSA Handbook
interim bonus	A bonus which may be applied on claims occurring between formal declarations of reversionary bonus .
Intrinsic cost	The excess of the current value of a liability in a Realistic Balance Sheet (at the date as at which the Realistic Balance Sheet is prepared) over the current value (at such date) of the assets held to pay that liability
liabilities	The liabilities of the 90:10 Fund include, principally, guaranteed liabilities; liabilities in excess of guaranteed liabilities arising from the expectation that future bonus 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 bonus 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 90:10 Fund .
Long Term Business Fund	The funds of the Company which hold the assets available to meet the liabilities under the Company's long-term life and pensions policies.
Market Value Reduction (MVR)	A reduction which may be applied to the amount payable under a unitised with-profits policy under certain circumstances (such as on surrender, switch out of with-profits or on early or late retirement in the case of pensions policies) if the value of the assets backing the policy is lower than that reflected in the value of the with-profits units attaching to the policy. A Market Value Reduction may also be applied in the event of partial or total surrender of a conventional with-profits group deferred annuity scheme. A Market Value Reduction is sometimes called a Market Valuation Adjustment.

Maturity	The payment of policy benefits due on the maturity date (or for certain pension contracts the final annuity purchase date) specified in the policy. In the case of pension policies, the relevant date is referred to as the normal retirement date or selected retirement date, and there is generally a requirement to secure an annuity with part or all of the policy proceeds.
Miscellaneous profits or losses	Profits or losses which arise in a with-profits fund , but which are not credited or charged to asset shares .
Non-Profit Fund	A Long Term Business Fund which does not include any with-profits policies . All profits and losses arising in this fund, apart from any support provided to the with-profits funds in accordance with Appendix C, belong to shareholders.
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.
Put Option	A contract giving the right but not the obligation to sell an asset at a fixed price on a future date.
Realistic Balance Sheet	Form 19 of the Returns submitted to the Insurance Regulator in respect of either the 90:10 Fund or the 100:0 Fund
Realistic Deficit	The amount by which a Realistic Balance Sheet for a fund, would have revealed a deficit prior to the application of the relevant provisions of Appendix C
Regulator	The Financial Services Authority or any other regulatory body as defined in accordance with the provisions of the Financial Services and Markets Act 2000 or any superseding legislation.
reversionary bonus	A bonus which is added on a regular basis, usually annually, throughout the life of a conventional with-profits policy , providing an addition to the guaranteed benefits payable to the policyholder. Reversionary bonuses are sometimes referred to as annual bonuses.
Series 1 Units	In respect of UWP policies , the series of units with bid price and offer price that respond actively to movements in the underlying asset values but with an underlying guarantee price. These units are described more fully in Section 4.2.6.

Shareholder Fund	The fund of the Company that is separate from the Long Term Business Funds 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 with-profits fund . Smoothing also applies as a form of averaging claim payments over groups of with-profits policies in a with-profits fund .
Statutory Deficit	The amount by which, in the opinion of the Board, having regard to the advice of the With-Profits Actuary , the Regulatory Value of the Admissible Assets of a Fund is less than the Regulatory Value of all insurance and non-insurance liabilities of that Fund
Supervision Manual	The part of the FSA Handbook of rules and guidance setting out the manner in which the Financial Services Authority will manage its supervisory role over regulated companies.
surplus	In respect of a with-profits fund , profits or losses identified following an actuarial valuation of the assets and liabilities of the fund calculated using actuarial methods consistent with the relevant regulations. Some of the accumulated surplus will be deemed to be distributable in the form of bonuses from time to time.
surrender	The payment of policy benefits that discharges any future liability on the part of the Company to pay any subsequent benefits under the policy, such as those payable on maturity or death. Surrender terms are not usually guaranteed.
terminal bonus	A bonus which may become payable on a death, critical illness or maturity claim or on surrender. A terminal bonus is sometimes called a final bonus.
unitised with-profits (UWP) policy	A policy (or part of a policy) under which the value of the benefits is measured by reference to with-profits units allocated to that policy.
unit series	In respect of unitised with-profits policies , a series of with-profits units on which the same guaranteed rate of growth and the same declared rate of any annual bonus applies.

With-Profits Actuary	The function of With-Profits Actuary described in the Supervision Manual of the FSA Handbook , which principally involves advising the Board of the Company on its use of discretion in respect of with-profits business . The With-Profits Actuary is appointed by the Company .
with-profits business	The business of the Company which comprises with-profits policies .
with-profits funds	The 90:10 Fund and the 100:0 Fund .
with-profits policies	A policy which is entitled to share in the profits or losses of the with-profits fund in which it is held.
with-profits units	The units allocated to unitised with-profits policies by which the value of certain benefits is measured. The price of with-profits units (other than Series 1 Units , which are only allocated on certain policy types) increases in line with any guaranteed rate of growth applying to that unit series and with any annual bonus additions. The price of with-profits units (other than Series 1 Units) is guaranteed not to fall.

APPENDIX B – CALCULATION OF ASSET SHARES

B.1 Calculation of asset shares

ZA uses asset shares as a tool to help determine the appropriate bonus rates for different groups of policies. In broad terms, asset shares are a measure of the contribution of policies or groups of policies to the 90:10 Fund as a whole.

Asset shares are calculated as the accumulation of:

- premiums paid;
- plus investment returns on the assets in the 90:10 Fund which are deemed to support the particular group of policies;
- less expenses and commissions;
- less the cost of death and other applicable risk benefits;
- less an adjustment in respect of taxation;
- plus or minus surrender profits or losses from the group of policies in the 90:10 Fund;
- less the cost of shareholder transfers in respect of declared bonuses, adjusted for tax;
- plus any enhancement payable on the date of claim in respect of the distribution of the Estate.

B.2 Asset share assumptions

The assumptions underlying the determination of asset shares for individual UK-type policies (including policies written outside the UK but managed by the Company in the same way as for UK policies) are established as follows. Asset shares for overseas-type policies are determined using a similar approach, although there are certain relatively small differences reflecting the particular nature of the policy types in question.

B.2.1 Investment returns

Separate pools of assets within the 90:10 Fund are notionally allocated (or “hypothecated”) to support benefits for UK business (including Maltese business and certain other UK-type business written in the Isle of Man and the Channel Islands), Hong Kong business and other groups of overseas-type policies. The notional split of assets is applied for practical reasons so as to take account of the different nature of the policies from the different territories, although in practice all the assets of the 90:10 Fund are available to meet all policy benefits should financial circumstances be such as to make this necessary.

For each group of policies, the total investment income and capital gains or losses earned from the assets notionally allocated to the group is calculated as a percentage return on those assets, which is then credited to the asset shares of the policies in the group.

Investment returns for each calendar year on UK-type business are generally applied linearly over that year, i.e. they do not take account of fluctuations within the year.

For many years, circumstances have been such that the assets deemed to support UK-type business could be treated as a single pool. From 30 June 2009, the asset mix may be set separately for identified groups of policies to reflect the level of guarantees and the average outstanding term to the next guarantee date. For the time being the company may maintain separate asset mixes for life business, conventional pensions business excluding Esitran, conventional Esitran business, unitised pensions business and the assets backing guarantees and the Estate. These separate asset mixes are maintained to manage better the impact of guaranteed benefits within the business and to provide better protection for the 90:10 Fund as a whole as the business in the Fund runs off.

The pool of assets notionally allocated to a given group of policies may consist primarily of a mix of property and equity type assets and fixed and variable interest type assets and cash. The extent to which property and equity type assets are notionally applied in a given asset pool may vary according to the strength of the guarantees and the outstanding duration to the next major guarantee dates of the policies in that group, with policies where the guarantees are stronger or of shorter outstanding duration being notionally allocated a lower proportion of property and equity type assets and a higher proportion of fixed and variable interest type assets. It is possible that for policies of very short outstanding duration, or where the guaranteed benefits substantially exceeded the

corresponding asset shares, the proportion of property and equity type assets in the asset pool would be zero or close to zero. Furthermore, the average term to maturity of the fixed and variable interest type assets notionally allocated to a given asset pool may be chosen to reflect the average outstanding duration to the dates when guarantees apply in respect of the associated policies. The investment return credited to any such policy group may be increased on an annual basis by an allocation from the Estate to offset the possibility that some customers could in the longer term be disadvantaged by such an investment policy. Any such increase will be assessed on a long term basis and will not be dependent on the performance of the assets of the fund.

The notional split of assets is used for determining asset shares in normal circumstances but all the assets of the 90:10 Fund are available in practice to meet all policy benefits should financial circumstances be such as to make this necessary.

B.2.2 Expenses and commissions

Until 31 December 2004, expense allowances were calculated for all ZA policies based on what the Company considered to be a fair apportionment of the total management expenses. This allocation was made using accounting techniques which are generally accepted in the UK and which took account of the nature of the expenses incurred and the relative costs of writing and administering different classes of business.

An expense allocation using this approach is performed in respect of each calendar year, and the Company aims to ensure that any changes in the allocation are gradual. The allowances are expressed as an amount per policy for each product type to cover the processing of new business and maintenance of existing business, and these per policy amounts are charged to policy asset shares. From 31 December 2006 the amount to cover the processing of new business has been limited to no more than one annual premium for annual premium policies or 10% of the single premium for single premium policies.

For the period after 31 December 2004, on-going expenses for Group business continue to be charged to the fund using the approach above. On-going expense charges for individual business are made on a fixed basis increasing in line with the Average Weekly Earnings Index. These charges are calculated as an amount per policy and per claim for each product type to cover the maintenance of existing business. The charges are reviewable after 10 years.

Investment management fees are apportioned to the fund and individual asset shares in each calendar year for the corresponding hypothecated assets. Other investment costs are allowed for in the calculation of the investment returns.

For asset shares calculated from 31 December 2007, on-going expenses are charged to asset shares in line with any charges identified in the contract. For UWP business any remaining expenses and commission are charged as a proportion of asset shares subject to a maximum of 2% per annum.

For CWP business claims expenses are charged to policies becoming claims in the year. Other remaining expenses are charged as a proportion of sums assured. Commissions on CWP business are allowed for at the rates applying to each policy type on the Company's typical average commission levels at the time of issue. The typical commission levels are based on ZA's standard scale for the calendar year in question increased by the average level of commission enhancement (relative to the standard scale) that applied in practice in that year.

It is not practical to show the specific per-policy costs for all the different types of business in the 90:10 Fund, but by way of illustration the total expenses borne by the Fund during each of 2007, 2008 and 2009, including commission and investment management fees, equated to a charge of approximately 0.5% pa of the value of the assets of the Fund. The charges to individual contracts may be higher or lower than these percentages and this equivalent level of charge on the 90:10 Fund as a whole is not guaranteed in the future because expenses and other costs will continue to be allocated as described above.

B.2.3 Cost of risk benefits

Depending on the class of business, benefits payable on death and similar claims may be more or less than asset shares. For example, on most life policies, the death benefit (at least initially) will substantially exceed premiums paid, whereas on some pensions contracts there is little or no return on death. As a result, profits and losses will arise in the 90:10 Fund from risk benefit claims.

The Company undertakes regular investigations into the overall costs of providing such risk benefits. Based on the results of these investigations, an estimate of the cost of these benefits is built into the asset share calculations by multiplying the difference between the

value of the risk benefit and the asset share for that policy (the “Sum at Risk”) by the estimated probability that the risk event might have occurred. The estimated probability factor is based on an assessment of the average experience over the year for policies of a similar type and age of policyholder.

To the extent that profits or losses from these risk benefits differ from the estimated amounts applied to the asset shares of broadly similar groups of policies, they will increase or reduce the level of the Estate.

B.2.4 Taxation

Within the sample asset share calculations for life business, tax is charged in respect of investment income and gains and tax relief is credited in respect of expenses. The tax rates used in each year reflect the rates of tax and tax relief that would have applied if the 90:10 Fund had been a stand-alone business independent of the other business of the Company. The prevailing policyholder tax rate is applied to income and indexed capital gains. It is assumed that there is always sufficient taxable income to relieve all expenses. For some gains and some categories of expenses, the normal tax rules allow for spreading of tax or tax relief over a period of seven years, and this is reflected in the asset share calculations.

Tax on income and gains and tax relief on expenses are not applied to the asset shares of pensions policies, except to the extent that there is a need to reflect unrecoverable taxes or tax credits.

The tax allocated to the 90:10 Fund also includes tax on investment income and gains in respect of assets in excess of the sum of the asset shares of the policies invested in the 90:10 Fund.

From 30 June 2005, any tax liability in respect of a distribution of surplus is attributed to the estate, so asset shares are unaffected. For distributions of surplus made prior to 30 June 2005 any tax liability was attributed to the asset shares.

ZA’s tax computations are carried out at a company level. Any difference between the actual tax payable and the amount notionally allocated to the 90:10 Fund through the above mechanism is met from (or credited, as the case may be) outside the 90:10 Fund.

B.2.5 Surrender profits or losses

Surrender profits or losses arise when the surrender values paid out from time to time differ from the asset share of the policies being surrendered.

In the asset share calculations prior to 31 December 2007, surrender profits or losses were estimated based on the estimated proportion of policies surrendered in each year. The calculations were carried out separately for different product groups based on the surrender experience of the policies in that group.

Over time the estimates have become less reliable as a result of reduced numbers of policies in each product group. Therefore a new approach has been introduced from 31 December 2007. From that date, where for a given group there were estimated net surrender losses for periods prior to 31 December 2007 these net surrender losses have been charged to the estate. Where for a given group there were estimated net surrender profits, these net surrender profits have been added to asset shares. The change had little impact on payouts for most product groups.

For periods after 31 December 2007, actual surrender profits and losses are calculated using actual claims data. On CWP pensions policies where the surrender value methodology results in claims values in excess of asset shares, the resulting surrender losses are not charged to asset shares. For all other contracts surrender profits and losses arising after 31 December 2007 are applied to asset shares by reducing or increasing the allowance for expenses charged in the year.

B.2.6 Cost of shareholder transfers

Shareholders are entitled to receive 10% of the amount of any surplus distributed to policyholders in the form of bonuses. The cost of these shareholder transfers is allowed for in the accumulation of individual asset shares based on the bonuses allocated from time to time to the corresponding policies.

Until 31 December 2007 the cost of the shareholder transfer was derived using the same basis as the liabilities reported in the regulatory returns. For distributions made after 31 December 2007 the cost of shareholder transfers will be derived using the same basis as the liabilities reported in the regulatory returns except that the FTSE 15 year UK Gilt Index Yield will be used in place of the valuation rate of interest whenever that yield is

higher than the valuation rate of interest used for regulatory reporting. Where the higher yield applies this will reduce the amount of the surplus allocated to shareholders.

B.2.7 Estate distribution

From 1 January 2009, the Estate will be distributed to customers using the bonus or MVR mechanism by considering whether to include an enhancement within asset shares at the time of the claim. Any enhancement to asset share will be expressed as a percentage addition to the asset share which will be reviewed at each bonus declaration. The enhancement could be altered or removed at any time depending on the experience of the fund. The enhancement percentage will apply to the asset share of all UK-type policies claiming at a given time. If an enhancement is made to asset shares, claims payments may increase as a result of increased terminal bonus rates, reduced MVRs on UWP contracts or increased surrender values on CWP contracts. For the purposes of determining any distribution of the estate, ZA reserves the right to exclude any new investment into the fund that is made after 1 April 2009.

Essentially, 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 bonus distributions and any other appropriate adjustments) is approximately equal to the total financial resources of the 90:10 Fund including the Estate. By adopting such an approach, ZA expects the Estate to run down to zero over time broadly in line with the run-off of the business after taking into account business risks faced by the Fund. To make allowance for the risks that the fund is still exposed to, the enhancement percentage is likely to be lower than the percentage of total asset shares that the estate represents.

B.3 Asset share calculations

Asset shares are calculated for each policy provided that the necessary historical data is available. The calculation is carried out in monthly steps, although within that it does not allow for the exact incidence of any cash flows. ZA believes this approach does not introduce any material inaccuracy or distortion.

For some classes of business, it may not always be possible to calculate asset shares in the manner set out above. For example, the full record of premiums paid in respect of a given

policy might not be available (as might happen, typically, for group pensions policies where premiums are very variable). For Whole of Life and certain pension products where there are few policies remaining asset shares are not calculated. The bonus rates for these products are set to those of the most similar product for which asset shares are calculated.

B.4 Controls and Documentation

ZA maintains appropriate systems in order to determine asset shares and hence claim values for with-profits policies in the 90:10 Fund. These systems may be upgraded or replaced from time to time but ZA takes care to ensure that any such changes will not materially reduce its ability to comply with the principles and practices set out above. Asset share assumptions in respect of more recent experience are reviewed at least annually, and more frequently if necessary.

ZA does not currently intend to change the asset share methodology described above in respect of calculations of asset shares to date. ZA would consider changing the methodology applied in respect of future years if new techniques were developed which became standard accepted practice in the UK life insurance industry, if there were any relevant changes in regulations, or if to do so would correct any material errors or materially improve the accuracy of the calculations.

Historical assumptions for the accumulation of asset shares have been calculated in respect of each calendar year to date, and these have been documented. ZA does not generally review or update these assumptions, although the Company would consider making retrospective changes to the assumptions if a material error were discovered that might lead to inequity between classes of policyholder.

Material changes to asset share methodology and assumptions require the approval of the With-Profits Actuary. If such changes are likely to have a significant impact on the amounts payable on claims, they must be approved by the Board.

Further information on the processes for changing assumptions, methodology and systems used to support with-profits business is given in Section 11.

APPENDIX C – FINANCIAL SUPPORT

C.1 Introduction

This support mechanism was set out in the court documents relating to the scheme of arrangement effective 1st January 2005. This section provides a simplified description of the support mechanism of the 90:10 Fund. A similar support mechanism applies to the 100:0 Fund. The full text is available on request. Any conflict in the application of the support mechanisms will be resolved by the ZA Board having regard to the advice of the With-Profits Actuary.

C.2 Statutory Support

If a Statutory Deficit has arisen in the 90:10 Fund then a Contingent Loan for this amount will be made from the DCP Fund, the NP Fund or the SH Fund.

At the end of each quarter, all loans made during this period will be assessed. The 90:10 Fund will pay the accrued interest on the loans to the Lending Fund. If by paying this interest, a new Statutory Deficit is created then a new Contingent Loan sufficient to eliminate the deficit is made. The 90:10 Fund will pay back any Contingent Loans but only if it doesn't create a Statutory Deficit or Realistic Deficit. The Board, having regard to the advice of the With-Profits Actuary, will decide the extent to which loan repayments should be made.

To avoid any doubt, the Lending Fund shall not be entitled to set off any amount owing to it in respect of a Contingent Loan and Interest against any amount owed by it, to the 90:10 Fund. The lending funds irrevocably waive any right they have to set off these amounts to the extent allowed for by law.

C.3 Realistic Support

If there's a Realistic Deficit in the 90:10 Fund after allowing for the Statutory Support described above, the following support mechanism shall apply

A. Shareholders will conditionally waive their rights to transfers from the 90:10 fund. If in future, the realistic balance sheet shows no realistic deficit or a reduced one, then the waiver will be rescinded.

B. This paragraph applies if waiving the Shareholders rights as in A above isn't enough to eliminate the Realistic Deficits. Part of the right of the DCP Fund to payments from the 90:10 Fund to cover the cost of purchasing Pension Benefits will be conditionally waived. If in future, the realistic balance sheet shows no realistic deficit or a reduced one, then the waiver will be rescinded.

C. Any remaining Realistic Deficit after the application of sub-paragraphs A. and B. shall be addressed as follows:

- (1) the part of the Realistic Deficit relating to Intrinsic Cost shall be immediately extinguished by the transfer of property from the Lending Fund; and
- (2) the part of the Realistic Deficit relating to Future Volatility Cost shall be met by a charge on future surpluses (calculated before any transfer to the investment reserve) projected to arise in the Lending Fund.

D. Any remaining Realistic Deficit following the application of sub-paragraphs A., B. and C. shall be extinguished by a transfer of property to the 90:10 Fund from the Shareholders' Fund.

E. For the avoidance of doubt, if any future Realistic Balance Sheet demonstrates that not all elements of support specified in this paragraph continue to be required, the elements of support shall be withdrawn in the reverse order of application.

If a Realistic Deficit remains and ZA doesn't have enough free assets to meet any Individual Capital Guidance applicable, a reduced Realistic Basis Contingent Loan may be made from the Lending Fund to the 90:10 fund. After each quarter, the 90:10 fund will pay interest on the Contingent Loan to the Lending Fund. If paying this interest means another Contingent Loan is needed then another loan will be made. The 90:10 fund will pay back the Contingent Loan when there is no longer a deficit. For this to happen though, the Board, having regard to the advice of the With-Profits Actuary, has to agree that the repayment is consistent with the obligations to pay due regard to the interests of customers and to treat them fairly.

If there's a Realistic Deficit in either of the Realistic Balance Sheets for the 90:10 fund and the 100:0 fund then the support will be provided in proportion to the Realistic Deficits in these funds.

Additional technical provisions will be maintained in the NP Fund and the DCP Fund to the value of the Eliminated Deficit Assets. The Eliminated Deficit Assets shall be recalculated by the Board, having regard to the advice of the Head of the Actuarial Function. The recalculation will happen at least once every 12 months.

APPENDIX D – OVERSEAS TYPE BUSINESS

D.1 Overview

This Appendix summarises the practices used to determine the amounts payable on claims and the practices relating to bonus policy, smoothing, and investment strategy for overseas-type with-profits business written in the ZA 90:10 Fund. This business includes Eagle Living and Provident Fund policies written through the Hong Kong branch and Cosmos and Domus policies written through the Isle of Man branch. There is also a small number of Eagle Living policies which were written directly in the UK. ZA is closed to new overseas-type with-profits policies.

D.2 Amounts Payable on Claims

Premiums are allocated to units and charges are levied in accordance with policy conditions. On surrender, death or maturity the realisable value of the policy is payable in accordance with the policy conditions. The realisable value on surrender, death or maturity will include any dividends accrued up to the date of the claim, subject to any minimum value or guarantee that may be included in the policy conditions. On funds that offer steady growth to support guaranteed maturity values or guaranteed investment returns, there may be restrictions on surrenders out of the fund and the realisable value on surrenders may incorporate a Market Value Reduction in order to protect the interests of continuing policyholders in the 90:10 Fund.

D.3 Dividend Policy (Bonus Policy)

ZA's policy on dividends (which is the term commonly used when referring to bonuses) on the overseas-type business is strongly influenced by the investment strategy of the fund(s) supporting particular groups of policies. The investment returns earned on a fund in any period less any contractual charges generate the available earnings out of which the dividends for that period are declared. For any particular fund the distributed earnings closely reflect the available earnings and the declared dividends account for at least 90% of the distributed earnings.

The annual dividends declared on funds that offer steady growth to support guaranteed maturity values or guaranteed investment returns also take account of the future dividends that the funds are expected to be able to generate based on the assets they hold and the

liabilities they support. An interim dividend may also be paid on claims on these funds to allow for any distributable earnings not reflected in the latest annual dividend. For funds that invest in bank deposits or mutual funds, the monthly dividends declared closely follow the performance of the assets of the fund. No terminal dividends are paid on claims because the annual and interim dividends or the monthly dividends fully reflect the available earnings that can be distributed to policies.

D.4 Smoothing

Limited smoothing may apply on funds that offer steady growth to support guaranteed maturity values or guaranteed investment returns. For example, changes between the annual dividends declared out of past earnings to the annual dividends that are expected to be supportable in the future may be smoothed in over a few years. The impact of this smoothing is limited given that the annual dividends are intended to reflect closely the distributable earnings for the whole portfolio of policies invested in the fund. On funds invested in bank deposits or mutual funds, the monthly dividends closely reflect the distributable earnings and incorporate little smoothing.

D.5 Investment Strategy

Overseas-type contracts are supported by funds with investment strategies that are quite distinct from the investment strategies of the rest of the 90:10 Fund relating to UK-type conventional and unitised with-profit policies. Funds that are intended to provide steady growth to support guaranteed maturity values or guaranteed investment returns are invested in bonds with good credit ratings denominated in major currencies that are a good match to the liabilities. There are also funds that invest in bank deposits or mutual funds.

APPENDIX E – EAGLE/MIDLAND POLICIES

E.1 Overview

This Appendix summarises the practices used to determine the amounts payable on claims and the practices relating to bonus policy, smoothing, and investment strategy for Eagle/Midland Unit Policies (“EUPs”) and Unit Investment Policies (“UIPs”). Only a very small number of EUPs and UIPs remain in force because they were part of product lines that were closed to new business many years ago.

E.2 Amounts Payable on Claims

Premiums are allocated to units in accordance with policy conditions. On death or maturity, the greater of the realisable value of the unit holding and any minimum value in the policy conditions based on the Nominal Sum Assured (“NSA”) is payable. On surrender the realisable value of the unit holding is payable. The realisable value of the unit holding is the bid value of the units increased by any accrued bonuses and reduced by an allowance for capital gains tax (“CGT”). An allowance for CGT is applied on claims because there is no allowance for CGT in the unit prices. The rate of CGT that is applied is intended to broadly reflect the rate of policyholder tax on capital gains that is borne by the 90:10 Fund. Tax legislation may be changed at any time and therefore the rate of CGT applied on claims is liable to change.

E.3 Bonus Policy

Annual bonuses on EUPs are based on surplus equivalent to 1% of the NSA plus approximately one-third of the net income generated by the unit fund. Annual bonuses on UIPs are based on surplus approximately equivalent to the net income generated by the unit fund. On both EUPs and UIPs annual bonus rates may be rounded up or down. Bonus rates may be rounded to zero where the available surplus is trivial, e.g., where it is equivalent to a yield that is a fraction of 1%.

Unit prices fully reflect all capital appreciation or depreciation on the unit funds. Therefore no terminal bonuses are payable on claims and similarly no MVRs apply on claims.

E.4 Smoothing

A degree of smoothing is applied to annual bonuses, typically by rounding-off the bonus rate to a percentage value that does not include any fractions. Overall claim values incorporate very little smoothing because unit prices fully reflect all capital appreciation and depreciation in the unit funds.

E.5 Investment Strategy

Both EUPs and UIPs are backed by unit funds having investment strategy that is quite distinct from the investment strategies of the rest of the 90:10 Fund relating to CWP and UWP policies. Since 1997, the investment strategy for EUPs has been the same as the Managed Fund. UIPs participate in the performance of the Scottish Widows Investment Partnership Global Open Ended Investment Company.