The co-operative financial services
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Annual Report to With-Profits Policyholders on Compliance with The Principles and Practices of Financial Management (PPFM)

Contents

Summary

The Board of Directors of Co-operative Insurance Society Limited believes that, during the period 11 January 2009 to 31 December 2009, we have complied fully with the obligations relating to our Principles and Practices of Financial Management (PPFM).

These obligations are that we should maintain appropriate governance arrangements designed to ensure that in the conduct of with-profits business we comply with, maintain and record any applicable PPFM.

The following report sets out the Board's reasons for this opinion.

Report on compliance with the PPFM for 2009

1. Introduction

On 30 April 2004, we published our Principles and Practices of Financial Management (PPFM), which describe the management of our with-profits business. Three PPFM documents were published, covering our Long Term Business Fund (LTBF), With-Profits Stakeholder Fund (WPSF) and With-Profits Pension Fund (WPPF).

All firms operating with-profits funds must report each year to policyholders on compliance with the obligations relating to their PPFM. These obligations are that firms should maintain appropriate governance arrangements designed to ensure that in the conduct of with-profits business it complies with, maintains and records any applicable PPFM.

This report covers:

- governance arrangements for with-profits business;
- how we have exercised discretion in managing our with-profits business;
- how we have addressed any competing or conflicting rights, interests or expectations; and
- changes to the PPFM documents and the communication of these to policyholders.

This report covers the 2009 financial year, from 11 January 2009 to 31 December 2009.

Any terms used in this report have the meaning set out in the PPFM documents, which can be found on our website co-operativeinvestments.co.uk.

2. Governance arrangements for with-profits business

In order to ensure that we are managing our with-profits business in accordance with the PPFM documents, we have appointed a With-Profits Actuary and a With-Profits Committee.

2.1 The role of the With-Profits Actuary

The With-Profits Actuary (WPA) advises the Board on PPFM compliance, treating with-profits policyholders fairly, areas of discretion in managing its with-profits business and potential conflicts of interest. The WPA also reviews any material relevant to the management of the with-profits business, including communications to with-profits policyholders. We have appointed Shaun Cooper, who is an employee of CFS Management Services, a subsidiary of Co-operative Financial Services Ltd (CFS), as our WPA.

Terms of reference for the WPA were approved by the Board. In addition, detailed governance arrangements for the management of long-term business were approved by the CFS Executive.

The WPA's report to policyholders in respect of 2009 can be found in Appendix A.

2.2 The role of the With-Profits Committee

Towards the end of 2009 we established a With-Profits Committee (WPC) to oversee the management of our with-profits business. One of the responsibilities of the WPC is to ensure we have managed our with-profits business in accordance with the PPFM documents each year. The committee consists of the Co-operative Insurance Society non-executive directors David Davies, Chris Jones and Paul Flowers. The independent member of the WPC is Nick Dumbreck, who is an actuary employed by Milliman Ltd.

The With-Profits Committee raised no material concerns in the review for 2009.

Prior to the WPC being established, independent oversight of the management of our with-profits business was provided by Michael Arnold, an independent actuary employed by Milliman Ltd. who acted in the role of Independent Reviewer.

The report of the WPC in respect of compliance with the PPFM for 2009 can be found in Appendix B.

3. How we have exercised discretion in managing our with-profits business

In order to confirm that we have complied with our obligations as set out in the PPFM documents, a detailed review has been undertaken of these obligations and of the way in which they have been fulfilled during 2009. A summary of the findings of this review is provided below.

3.1 Bonus rates and market value reductions

There were two bonus declarations during 2009:

- revised annual bonuses, final bonuses and Market Value Reductions (MVRs) were declared in April 2009;

- revised final bonuses were declared in October 2009.

Both declarations were reviewed by the WPA and the Independent Reviewer. Both declarations were approved by the Board, which was advised by the WPA that the declarations were consistent with the PPFM.

3.2 Investment policy

Investment policy is regularly reviewed and changes are made as appropriate in the interests of all policyholders.

No changes were made to the investment policy during the 2009 financial year. The target range for assets invested in riskier assets such as equities and property is 55%-75% for Accumulating With-Profits business and 40%-60% for Traditional With-Profits business. In addition, interest rate swaps are used to remove most of the interest rate risk on Table P policies.

The proportions of riskier assets backing with-profits policies are regularly monitored and were within the target ranges stated in the PPFMs during 2009.

The investment practices remain those stated in the PPFM. In particular:

- all non-profit policies are closely matched with fixed-interest securities;

- as at 31 December 2009, 55% of the assets backing traditional with-profits business were invested in riskier assets such as equities and property, with property comprising 24% of the total equity and property assets;

- as at 31 December 2009, 70% of the assets backing accumulating with-profits business were invested in riskier assets such as equities and property, with property comprising 26% of the total equity and property assets;

- assets backing guarantee costs are invested in fixed-interest securities and, in the case of guaranteed annuity rates, appropriate interest rate swaptions and interest rate swaps;

- the working capital of the LTBF is invested mainly in fixed-interest securities;

- as at 31 December 2009, 67% of the assets in the WPSF were invested in riskier assets such as equities and property; and

- as at 31 December 2009, 66% of the assets in the WPPF were invested in riskier assets such as equities and property.

The WPA was involved in the monitoring and review of the investment policy throughout 2009. Investment policy has been applied consistently with the PPFM during 2009.

3.3 New business plans and premium rates

We regularly review the volume and mix of new business that is written in the fund. The impact that new business has on the LTBF's working capital was assessed during 2009. We will continue to write new business in the fund provided this is not expected to have a materially detrimental effect on the existing business within the fund.

The WPA was involved in the review of volume and mix of new business in 2009.

3.4 Charges and expenses

We aim to set charges on with-profits business that are at least sufficient to meet the expenses associated with this business. These charges cover the costs of selling and administering the business and the cost of managing the investments backing the business. The methods for allocating these expenses between the different Co-operative businesses that share central overheads, and between different groups of policyholders, are reviewed regularly.

No changes to the expense allocation principles were made in 2009. Any changes to the expense allocation principles are overseen and approved by a Cost Allocation Governance Group, of which the WPA is a member.

Charges in the Stakeholder With-Profits Fund are no more than the maximum permitted under the Stakeholder regulations.

Change programme costs which aim to improve the efficiency of servicing our business have been incurred.

- The share of these costs that relates to traditional with-profits business has been deducted from the asset shares of those policies.

- An exception to this is that the one-off development costs associated with outsourcing the administration of our Life and Savings business to an external company have been, and will continue to be, charged to working capital.

- For accumulating with-profits business, management charges are deducted at the rates described in documents issued to policyholders. As a result, all of the change programme costs allocated to this class of business have been charged to the working capital which will benefit from future savings in servicing costs for this class of business.

Compensation costs arising from non-profit business have been met from interest on the General Reserve, and have therefore not been charged to with-profits policyholders.

4. How we have addressed any competing or conflicting rights, interests or expectations

4.1 Equity between with-profits policyholders and shareholders

The ultimate shareholder parent of CIS Ltd is the Co-operative Group. Profits from the Long-Term Business Fund continue to be used for the sole benefit of long-term business policyholders including the making of reserves to preserve the financial strength of the fund.

4.2 Equity between different groups of with-profits policyholders

Different groups of with-profits policyholders could have competing or conflicting rights, interests or expectations. These groups could include different product types, policies with different terms, premium size or frequency, policies with different start dates and policyholders making claims on death, surrender or maturity.

The following areas of discretion affect how these potentially conflicting interests are managed:

- smoothing of benefits;
- grouping of policies when setting bonus rates.

During 2009, smoothing of policy benefits conformed with the statements made in the PPFM documents.

For the purpose of setting bonuses, policies with similar characteristics were grouped together. Policies were grouped by product type and start date in order to ensure that policies received a fair share of investment, expense and mortality profits and losses.

5. Changes to the PPFM documents and the communication of these to policyholders

The PPFM documents are reviewed regularly to ensure that they remain up to date.

The PPFM were unchanged in 2009 and were last updated in June 2008. The up to date PPFMs can be found on our website co-operativeinvestments.co.uk.

Records of historic PPFM documents are kept, along with details of the changes made to each document.

09 June 2010

Appendix A

Report from the With-Profits Actuary

As With-Profits Actuary, it is my responsibility to advise the Board of Co-operative Insurance Society Ltd on the management of the company's with-profits business.

In my opinion Co-operative Insurance Society Ltd has managed its with-profits business in line with the approach set out in the PPFM documents and has taken the interests of with-profits policyholders into account in a fair and balanced way.

In reaching this opinion I have taken into account the information and explanations provided to me by Co-operative Insurance Society Ltd, and any relevant rules, regulations and guidance issued by the Financial Services Authority, the Board of Actuarial Standards and the Actuarial Profession.

Shaun Cooper
Fellow of the Institute of Actuaries

With-Profits Actuary
Co-operative Insurance Society Ltd
9 June 2010

Appendix B

REPORT FROM THE WITH-PROFITS COMMITTEE

1. Scope

1.1. Every life insurance company transacting with-profits business is required to maintain a document setting out the PPFM by which it manages its with-profits business. This document is public and is available to any policyholders who require a copy. The PPFM represents a framework within which the company expects to work, but it generally leaves a significant amount of flexibility to the firm and discretion to its board of directors in application.

1.2. Firms are required to establish procedures to ensure that there is appropriate challenge to actions proposed by the board under the terms of the PPFM, and independent review of the application of the discretionary powers granted in the PPFM. The independent review may take several forms but under each form the individual or body undertaking the review has to report annually to the board of the firm on the firm's compliance with the PPFM. The Board has to report to policyholders on its compliance with the PPFM. This report should include a report from the firm's with-profits actuary ("WPA") on the use of discretionary powers. The independent review report need not be made public but may be if the firm so chooses or the independent review function requires it.

1.3. CIS has previously used an independent reviewer to provide this challenge and review but has created a with profits committee ("WPC") to undertake this function from January 2010. Although the WPC was not responsible for the challenge to CIS actions during 2009, it will be responsible for providing the independent report of on compliance with the PPFM for that year.

2. Background to CIS

2.1. A separate long term business fund ("LTBF") is maintained for life insurance business and both with-profits and non-profit business are written in the same fund. The LTBF operates on mutual lines in that all profits arising in the fund remain there for the benefit of all of the long term business customers and are not shared with the shareholder. This model reflects the co-operative model of operation.

2.2. Non-profit business in the LTBF is not priced with the intention of maximising the profit which can be made for the benefit of the LTBF (or the with-profits policyholders) but is priced to ensure as far as possible that the premium meets the risks and provides for the use and replenishment of the capital of the fund used in transacting this business.

2.3. The LTBF is managed having regard only to the capital available in the LTBF although additional capital is available in the share capital and in the General Reserve in certain extreme circumstances.

2.4. There are three separate funds for with-profits business within the LTBF, each of which has its own PPFM. These are:

- Long Term Business Fund,
- With-Profits Pension Fund, and,
- With-Profits Stakeholder Fund.

2.5. The With-Profits Pension Fund has been established to manage unitised with-profits pension business issued by CIS, apart from with-profits stakeholder pension business which has capped management charges and which is allocated to the With-Profits Stakeholder Fund. Participants in these two funds only share in the profits generated in the fund to which they are allocated. All other with-profits business is allocated to the Long Term Business Fund. With-profits business allocated to the Long Term Business Fund participates in the profits generated from transacting with-profits business and may also benefit from allocations from other miscellaneous profits of the LTBF, at the discretion of the CIS Board.

2.6. Responsibility for managing the LTBF lies with the CIS Board, as does the responsibility for compliance with the PPFM. The CIS Board is advised by the WPA as to the appropriate application of the powers available to it, but the CIS Board is free to accept, modify or reject that advice.

3. PPFM History

3.1. The overarching Principles set out in the PPFM are not expected to change frequently but, if changes are required, these must normally be notified to with-profits policyholders prior to the change being adopted. On the other hand, the Practices must be applied within the context of the Principles and may alter more frequently to reflect external pressures such as economic or market conditions, or changes to regulatory or taxation requirements. Changes to Practices must also be notified to policyholders but may be done so after the event.

3.2. The versions currently applicable are:

- Long Term Business Fund: June 2008
- With-Profits Pension Fund: June 2008

- o With-Profits Stakeholder Fund: June 2008

3.3. There have been no changes to either the Principles or the Practices set out in the versions listed above during 2009.

4. Compliance with Practices

4.1. It is reasonable to report on the application of, and compliance with, the PPFM under a number of general headings which correspond to the key discretionary powers available to CIS:

- o Actuarial advice,
- o Setting investment policy,
- o Allocation of expenses to the LTBF,
- o Deriving asset shares,
- o Setting bonuses (and claim amounts),
- o New Business,
- o Excess Capital,
- o Exceptional events.

4.2. These headings apply generally under each of the PPFM. They apply fully to the Long Term Business Fund but more narrowly to each of the With-Profits Stakeholder Fund and the With-Profits Pension Fund as the scope of their PPFM is limited, e.g., there is no allocation of expenses to these funds and the types of policy allocated to each fund are restricted.

4.3. A range of evidence has been provided on the way CIS has applied its discretion under these general headings which represent the routine aspects of the operation of the LTBF. These discretionary powers have been applied consistently and appropriately, and have had due regard to the differing interests of each class of with-profits policyholder within the LTBF.

5. Conclusion

5.1. In our opinion, CIS has managed its with-profits business appropriately and in accordance with each of its PPFM.