

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)**

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Summary

The Board of Directors of Co-operative Insurance Society Limited believes that, during the period 1 January 2010 to 31 December 2010, 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 2010

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 2010 financial year, from 1 January 2010 to 31 December 2010.

Any terms used in this report have the meaning set out in the PPFM documents, which can be found on our website www.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) is a statutory role with defined responsibilities. In particular, the 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.

In the earlier part of 2010 our WPA was Shaun Cooper, an employee of CFS Management Services, a subsidiary of Co-operative Financial Services Ltd (CFS). In September, following a review of governance in our life & savings business, we decided to strengthen the independence of the WPA actuary role. We appointed Nick Dumbreck, who is a senior partner at Milliman Ltd, as our new WPA.

The WPA's report to policyholders in respect of 2010 can be found in Appendix A.

2.2 The role of the With-Profits Committee

The With-Profits Committee (WPC) was established in 2009 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.

In the earlier part of 2010, the committee consisted of the Co-operative Insurance Society non-executive directors David Davies, Chris Jones and Paul Flowers. The independent member of the WPC was Nick Dumbreck.

Following the review of governance in our life & savings business, we decided to strengthen the independence of the WPC and enhance the committee's terms of reference.

The reconstituted WPC consists of:

- David Keeler, an experienced consulting actuary having spent over 25 years with the Tillinghast insurance consultancy business of Towers Perrin, where he was Principal for 20 years;
- Bridget Rosewell, an experienced economist and founding director and executive chair of the economic and marketing analysis firm Volterra Consulting Limited;
- David Davies, the senior independent director of the CIS Board. David is the Chair of Sun Life Assurance Company of Canada (UK) and Nortel Networks Pension Scheme in the UK, and is a non-executive director of Interglobal Insurance Company Limited; and
- Chris Jones, an independent director of the CIS Board. Chris is a member of the Institute of Credit Management, the Law Society and a Fellow of the Royal Society of Arts and of the Association of Business Recovery Professionals. Chris runs Tourmalet Consulting, specialising in business turnaround and is a non-executive director of Agenda Management Services Limited, Armitage Jones LLP, Montpellier Business Reorganisation Limited, Trango Ltd and The Business Desk and is Chair of Illius Properties Limited.

David Keeler is the Chair of the WPC, and has the casting vote.

The terms of reference for the WPC can be found on our website www.cfs.co.uk

The With-Profits Committee raised no material concerns in the review for 2010.

The report of the WPC in respect of compliance with the PPFM for 2010 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 2010. A summary of the findings of this review is provided below.

3.1 Bonus rates and market value reductions

There were three bonus declarations during 2010:

- Revised final bonuses and Market Value Reductions (MVRs) for Accumulating With-Profits business were declared in February 2010;
- Annual bonuses and revised final bonuses for Traditional With-Profits business, and annual bonuses for Accumulating With-Profits Funeral Plans were declared in April 2010;
- Revised final bonuses for Traditional With-Profits business were declared in October 2010.

No material concerns regarding these declarations were raised by the WPA. All declarations were approved by the Board, which was advised by the WPA that the declarations were consistent with the PPFM.

3.2 Investment policy and business risks

Investment policy has been applied consistently with the PPFM during 2010. No material concerns have been raised by the WPA following the monitoring and review of the investment policy throughout 2010.

(A) CIS Long-Term Business Fund

Investment Policy

Investment policy is regularly reviewed and changes will be made as appropriate in the interests of all policyholders. From March 2010, up to 3% of the corporate bond portfolio has been allowable to be invested in sub-investment grade bonds, rated at least CCC.

The investment practices remain consistent with those stated in the PPFM, namely:

- (i) all non-profit policies are closely matched with fixed-interest securities;
- (ii) as of 31 December 2010, 72% of the assets backing accumulating with-profits business were invested in riskier assets such as equities and property, with property comprising 25% of these riskier assets;
- (iii) as at 31 December 2010, 57% of the assets backing traditional with-profits business were invested in riskier assets such as equities and property, with property comprising 22% of these riskier assets;
- (iv) assets backing guarantee costs are invested in fixed-interest securities and, in the case of assets backing guaranteed annuity rates, appropriate interest rate swaptions, interest rate swaps and gilt swaps;
- (v) the working capital of the fund is invested mainly in fixed-interest assets.

To better match the term of the liabilities, interest rate swaps have been specifically allocated to Table P pension business.

Business Risks

Business risks continue to be regularly monitored and no significant business risks, other than those stated in the PPFM, were accepted.

Working Capital

During the financial year, the working capital of the fund was considered sufficient given the provisioning for risks, and consequently no actions to retain profits or distribute part of the working capital to policyholders were taken.

Compensation costs arising from pension and mortgage endowment mis-selling continued to be met from the working capital of the fund.

(B) CIS With-Profits Stakeholder Fund CIS With-Profits Pension Fund

Investment Policy

Investment policy is regularly reviewed and changes will be made as appropriate in the interests of all policyholders. No changes to investment policy were made in the period covered by this report.

The proportion of the funds invested in higher risk assets such as company shares as at 31 December 2010 was 66% for the CIS With-Profits Stakeholder Fund and 66% for the CIS With-Profits Pension Fund. As at 31 December 2010 neither fund held any property investments.

Business Risks

Business risks continue to be regularly monitored and no significant business risks, other than those stated in the PPFM, were accepted.

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 2010. 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.

No material concerns have been raised by the WPA following the monitoring and review of volume and mix of new business in 2010.

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 2010. Any changes to the expense allocation principles are overseen and approved by a Cost Allocation Governance Group. No material concerns have been raised by the WPA regarding the allocation of expenses during 2010.

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 except for certain

significant projects that are charged to working capital such as the one-off development costs associated with outsourcing the administration of our Life and Savings business to an external company.

- 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 the LTBF.

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 and any Market Value Reductions (MVRs).

During 2010, smoothing of policy benefits conformed with the statements made in the PPFM documents.

For the purpose of setting bonuses and any MVRs, 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 documents were updated in July 2010, and all changes were approved by the Board. No changes were made to the Principles in the PPFM documents. Details of the changes to the Practices were communicated to policyholders at the same time as they received their annual statements. The up to date PPFMs can be found on our website www.co-operativeinvestments.co.uk.

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

5.1 July 2010 PPFM changes

LTBF Policyholders

Changes to how we manage the Long-Term Business Fund

The following wording accompanied statements issued after the July change:

We have added some wording to explain:

- how we govern the management of the fund to ensure policyholders are treated fairly;
- how early and late retirement claims are determined for Option 32 pension policyholders; and
- how certain types of investments known as derivatives are used in managing the fund.

WPPF and WPSF policyholders

The changes to the WPPF and WPSF PPFMs were deemed not to be material in terms of communications to policyholders.

15 June 2011

Appendix A

Report from the With-Profits Actuary

To the With-Profits Policyholders of the Co-operative Insurance Society Ltd (“the Society”)

I became With-Profits Actuary to the Society on 30 September 2010. In this capacity, it is my responsibility to advise the Board of CIS on the management of the company’s with-profits business, and to report annually to with-profits policyholders on the exercise of discretion in relation to that business.

In my opinion the attached report and the discretion exercised by the Society’s Board in respect of 2010 may be regarded as having taken the interests of with-profits policyholders into account in a reasonable and proportionate manner.

In reaching this opinion I have taken into account the information and explanations provided to me by the Society, relevant rules and guidance issued by the Financial Services Authority and applicable standards and guidance issued by the Board for Actuarial Standards¹.

Nick Dumbreck
Fellow of the Institute and Faculty of Actuaries

With-Profits Actuary
Co-operative Insurance Society Ltd
15 June 2011

¹ TAS R (Reporting), TAS D (Data) and GN41 (The Role of the With-Profits Actuary)

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 established a With Profits Committee (WPC) to undertake the function of challenge and review. The WPC is responsible for providing the independent report on compliance with the PPFM.

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: July 2010
- With-Profits Pension Fund: July 2010

- With-Profits Stakeholder Fund: July 2010

3.3. There have been no changes to the Principles set out in the versions listed above during 2010. There have been some small changes to the Practices, which are summarised below:

- The wording in all three PPFMs has been revised to reflect changes to the with-profits governance model. Previous references to the Independent Reviewer have been replaced with reference to the WPC;
- The Long Term Business Fund PPFM has been updated to reflect a change in methodology for calculating early retirement benefits for Option 32 policyholders. Early retirement benefits within 5 years of the normal retirement age are now smoothed into the guaranteed contractual benefits that apply at normal retirement age.
- The Long Term Business Fund PPFM has been updated to reflect changes in the use of derivatives aimed at hedging the risks within the Long-Term Business Fund.

3.4. These changes were approved by the CIS Board in its meeting in July 2010. As the PPFM changes approved were immaterial there was no requirement to contact all policyholders affected by the change. However, it was agreed by the Board that those customers who receive annual statements would be informed of the changes at the time they receive their next statement. Updated versions of the PPFMs were also posted on the Co-operative Investments website.

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:

- Independent oversight,
- Actuarial advice,
- Setting investment policy,
- Allocation of expenses to the LTBF,
- Deriving asset shares,

- Setting bonuses (and claim amounts),
- New Business,
- Excess Capital,
- 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.