

**The Equitable Life Assurance Society
Principles and Practices of Financial Management**

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1. Introduction

This document sets out the Principles and Practices of Financial Management (the “PPFM”) applied in managing the with-profits business of Equitable Life Assurance Society (“Equitable Life” or “the Society”). The document has been approved by the Society’s Board of Directors (“the Board”).

The aims of this document are:

- (a) To set out the key features of the governance of the Society’s with-profits business, with particular reference to the use of discretion in managing that business; and
- (b) To provide information on the possible risks, rights and rewards attaching to the Society’s with-profits policies.

The document differentiates between “Principles” and “Practices”. The Principles are intended to be high-level statements that reflect the general approach adopted in managing the Society’s with-profits business and are expected to be enduring. If the Society feels it is appropriate to alter any of the Principles detailed in this document, with-profits policyholders will normally be notified, in writing, at least three months before any changes are implemented. The Society’s Principles can only be changed by the passing of a resolution of the Board.

The purpose of the Practices is to describe the Society’s current approach to managing its with-profits business and to responding to changes in the business and economic environment in the shorter term. These Practices may have to be changed to reflect changes in the circumstances of the Society and the business environment. Information about any changes to the Practices will be communicated to with-profits policyholders at the same time as annual statements are distributed or by way of separate correspondence, if this is considered appropriate by the Board.

The current version of the Society’s PPFM can be found on the Society’s website (www.equitable.co.uk) and paper copies can be obtained, free of charge, by with-profits policyholders of the Society by contacting the Society’s Call Centre on 0845 603 6771.

None of the contents of this document is intended to form part of, or vary, the terms or conditions of any policy issued or to be issued by the Society. In the event of any inconsistency between the contents of this document and any policy, the terms and conditions of the policy prevail.

This document is intended to assist knowledgeable observers to understand the way in which the with-profits business of the Society is conducted and the material risks and rewards involved in effecting or maintaining a with-profits policy with Equitable Life. It is not a comprehensive explanation either of the management of the with-profits business of the Society or of every matter which may affect that business. In addition, no part of the document should be read as a recommendation or advice to policyholders or potential policyholders or their advisers in relation to the effecting or maintaining of a with-profits policy. Accordingly, any person considering whether to effect or maintain a with-profits policy with Equitable Life should seek independent financial advice.

Statements in this document in relation to the risks and rewards involved in effecting and maintaining a with-profits policy with Equitable Life are by their nature forward-looking statements that are subject to a variety of uncertainties. Readers of this document should read such forward-looking statements in that context.

The contents of this document may be amended as a result of a change in the circumstances of the Society or the business environment. The document may also be amended to reflect changes made by the Society to the management of the with-profits business. The Society intends to give notice of any such change, as explained above, although in exceptional circumstances (such as to preserve solvency), changes could be made without notice.

Readers of this document should read the whole document. Reading only selected sections or paragraphs in isolation may result in a misleading impression of the way in which the with-profits business of the Society is conducted and the material risks and rewards involved in effecting and maintaining a with-profits policy with Equitable Life. The principles set out in this document and their associated practices should, in particular, be read together. Certain matters contained in this document are subject to continuing analysis and review by the Society and the FSA and may change as a result of that ongoing process.

The Society's Board of Directors has arrangements in place for an annual review to confirm that the with-profits fund has been managed in accordance with the Principles and Practices laid out in this document. The Board also produces an annual report for with-profits policyholders on the management of the with-profits fund. This can be found on the Society's website.

This version of the document is dated 25 March 2011 and replaces the version dated 30 June 2010.

2. Background Information on Equitable Life

2.1 Constitution and membership of the Society

a) Members of the Society

The Society is a mutual company and accordingly has no shareholders. Under the Articles of Association of the Society, its members essentially comprise persons who have taken out with-profits policies with the Society which remain in force and invested in with-profits. However, not all with-profits policyholders are members of the Society. For example, only a person to whom a with-profits policy was originally issued can be a member in respect of that policy - a person to whom a with-profits policy is subsequently assigned cannot be a member of the Society in respect of that policy. In addition, where a with-profits policy is held jointly by more than one person, only the first-named person on the policy can be a member in respect of that policy. In practice, most with-profits policyholders are also members of the Society.

Where the trustees of an occupational pension scheme take out a with-profits policy, only the first-named trustee on the policy can be a member of the Society in respect of that policy. Members of, or beneficiaries under, the occupational pension scheme will not be members of the Society by virtue of that policy.

b) Participation in the profits and losses of the Society

Although members of the Society have the right to attend and vote at general meetings of the Society, membership does not confer the right to share in the profits of the Society's business. Only with-profits policyholders participate in the profits and losses of the Society.

c) Liability of members for the debts of the Society

The Society is an unlimited company and accordingly the members of the Society are liable for its debts. However, the policies issued by the Society state that the Society's liabilities to its policyholders cannot exceed its assets. The purpose of this provision is to prevent members being called upon to meet the liabilities of the Society to its policyholders (whether under with-profits or non-profit policies).

Any liquidation of the Society would be governed by a statutory framework that is untested in the context of a life insurance company. That statutory framework gives the claims of insurance policyholders priority over the claims of other creditors. There is considerable legal uncertainty over how the statutory framework would operate in relation to liquidation of the Society in the light of the provisions included in policies issued by the Society, which state that the Society's liabilities to its policyholders cannot exceed its assets.

Should the Society go into liquidation, policyholders may have recourse to the Financial Services Compensation Scheme (the "FSCS") for the whole or part of the Society's liabilities to them depending upon the nature and quantum of their claims. The FSCS can also initiate measures should the Society be in default but not go into a formal insolvency process.

2.2 Types of with-profits policies issued by the Society

The Society closed to new business in 2000. This means that new policies are generally only issued where there is a regulatory or contractual obligation on the Society to do so in connection with existing policies, for example, allowing pension policyholders to effect an annuity on retirement.

The Society now has in issue two basic types of with-profits policy:

a) Recurrent single premium policies (“RSP policies”)

In aggregate, RSP policies account for the great majority of the Society's with-profits business. Under these policies, each premium, after deduction of charges, secures a guaranteed benefit. The aggregate of these guaranteed benefits is the minimum amount payable on the occurrence of specified events such as retirement or death. For the majority of RSP policies, the value of the guaranteed benefit is increased by a guaranteed investment return (the “GIR”), typically at the rate of 3.5% each year for policies issued before 1 July 1996, and 0% p.a. for policies issued after that date (meaning that the guaranteed benefits can never reduce except in the circumstances described in section 2.1(c)). A small number of RSP policies have GIRs at different rates. The guaranteed benefit is also increased by any reversionary bonuses declared, over and above the GIR.

The payout on the maturity of any RSP policy cannot be less than the guaranteed benefits, unless it is required to be reduced in the circumstances described in section 2.1(c).

b) Other with-profits policies

These policies include endowments and whole life policies and, in aggregate, account for a very small minority of the Society's with-profits business. Under these policies, an amount of guaranteed benefit is payable at a specified date or over a series of dates, or on the occurrence of a specified event. The guaranteed amount can be increased during the term of the policy through reversionary bonuses. A non-guaranteed final bonus may also be added at exit.

A small proportion of the Society's with-profits business is denominated in currencies other than Sterling. The products are similar to those described above.

2.3 The concept of “Policy Values”

For RSP policies, the Society has for many years used the concept of the "Policy Value" and the Society's administration system will generate a Policy Value in respect of each policy. A Policy Value normally represents a smoothed investment return (net of charges for expenses and tax and for the cost of guarantees) applied to the premiums paid into a policy and is used to determine payout levels in relation to with-profits benefits. Types of policy that do not use the concept of the Policy Value apply methodologies that are designed to have a similar effect.

The Policy Value is not a guaranteed amount - it can be reduced as well as increased, and it can be more or less than the value of guaranteed benefits under a policy. Policy Values are calculated at benefit level and each premium, net of explicit charges, adds to the Policy Value. Withdrawals reduce the Policy Value. Each year, and sometimes more often, the Board may decide to increase (or reduce) Policy Values, by a particular rate, or set of rates.

Policy Values are kept under regular review and may be changed at any time with immediate effect and without prior notice to policyholders. Changes to Policy Values are influenced by many factors, not just investment returns, and these factors are explained in section 4.2.1 below. However, the Society aims to smooth the effect of these factors.

The Society expects that Policy Values will only be decreased as a result of poor investment conditions or to protect solvency.

Changes to Policy Values, and to the method of calculating Policy Values, are determined by the Board. There have been no changes to the methodology for several years. The methodology for the calculation of Policy Values is described in this document and the Appendix summarises the most significant assumptions used in calculating Policy Values. The Society has formally documented the methodology in the form of a process map that is supported by written procedures for each step within the process.

2.4 The concept of “Capital Distribution”

The Society is required by the regulator to hold back 'solvency capital' to protect the Society against adverse economic and other events. However, it is the Society's intention to distribute all of the Society's assets amongst the with-profit policies as fairly as possible over the lifetime of those policies. Therefore, in order to ensure fairness between policies leaving and remaining in the with-profit fund, the Society needs to ensure that payout levels both distribute a fair share of the solvency capital of the fund and also leave sufficient solvency capital for those policies remaining.

To meet this objective, from 1 April 2011, the Society will calculate a “Capital Distribution Amount”, also referred to as an enhancement, on top of Policy Values to determine payouts. The Capital Distribution Amount will represent the Board's view of the prudent share of solvency capital to be earmarked for policyholders as at 31 December 2010. Thereafter, the Society's intention is that the level of the Capital Distribution Amount will be reviewed and determined at least annually, at a rate reflecting the Society's desired level of solvency capital. However, the enhancement is not a guaranteed amount - it can be removed, reduced or increased at any time, with immediate effect and without prior notice to policyholders.

2.5 Other with-profits business

Types of policy that do not use the concept of Policy Value will apply methodologies that are designed to have a similar effect. Payouts on these policies will also take into account the level of Capital Distribution Amount applicable at the time of exit.

3. Principles

The Society's with-profits business is managed in accordance with the following principles:

a) Management of the Society

The Society aims to manage its business in a sound and prudent manner for the benefit of all policyholders and, in particular, so that it can continue to meet its contractual obligations to policyholders and other creditors as they fall due.

b) Distributing all of the Society's assets

It is the intention of the Society that all of its assets, after providing for its contractual liabilities (including those to holders of non-profit policies and other creditors), will be distributed as fairly as possible amongst the holders of its with-profits policies over the lifetime of those policies. This means that amounts distributed amongst with-profits policies can exceed the contractual guaranteed entitlements of with-profits policyholders. Any amounts distributed amongst with-profits policies in excess of contractual guaranteed entitlements are decided after allowing for the requirement to meet the Society's contractual obligations as they fall due, and the need for the Society to maintain an appropriate level of solvency capital to operate its business.

In particular, in addition to the general need to hold solvency capital, the FSA also require that the Society prepares a confidential assessment of its solvency capital needs as introduced by the Individual Capital Adequacy framework (“ICA”). Upon receipt of this assessment, the FSA may issue confidential Individual Capital Guidance (“ICG”) which may result in a requirement that a particular level of solvency capital be held by the Society. This amount may be in excess of the ICA calculated by the Society. If it receives such an ICG, this could affect how the Society distributes its assets.

c) Bonus policy

In determining bonus policy, the Society aims to balance the objectives of continuing to meet its obligations to policyholders and other creditors as they fall due and of distributing the Society's assets over the lifetime of its policies as fairly as possible. Consideration is given to the overall financial position of the Society, which is affected by many things including, inter alia, investment returns and outlook, actual and expected expense levels, the expected cost of guarantees, miscellaneous profits and losses (including those from the non-profit business) and changes in the level of provisions. The rate at which surplus is distributed may vary depending on the Society's requirement for solvency capital, and the general level of uncertainty (for example, in the various provisions).

For the foreseeable future, any new distributions of surplus will be made in non-guaranteed form, and there is no expectation of any further reversionary bonus being awarded in the near to medium term. This applies across all product types and all territories. This approach aims to maximise the likelihood of the Society being able to meet all its future contractual liabilities.

The Society aims to set bonuses and payout levels which are fair across different groups and generations of policyholders. Profits and losses are typically shared across the whole of the with-profits business, not just among the policies concerned. For example, the cost of administration is shared across the whole of the with-profits business. Changes to Policy Values plus any Capital Distribution Amount and their equivalents are often the same for all policies within a particular class, but it is possible that they will vary between different groups and generations of policyholders.

d) Smoothing

The Society has a preference that changes in levels of bonuses and payouts should be gradual whenever circumstances permit, and reflect the underlying trend of investment returns. However, in adverse scenarios, especially when investment returns are poor, there is limited scope for smoothing. In particular, smoothing considerations will be overridden by the Society's need to be able to meet its contractual obligations to policyholders and other creditors as they fall due and any solvency capital requirements that the Society may have.

The Society considers smoothing in the context of its reviews of Policy Values plus any Capital Distribution Amount, rather than comparing the payout value of one policy with an equivalent one taken out a year earlier. This approach helps to avoid the amount paid under a policy being unduly distorted by reference to the experience of the fund in the year before the policy commenced.

e) Payouts on early surrenders

Where a policyholder surrenders his policy (or switches to a unit-linked fund) before maturity, contractual obligations in respect of payouts under the policy generally do not apply. The intention is that the amount paid to surrendering policies should be fair, but that it should not disadvantage continuing policyholders. In particular, the amounts paid to surrendering policyholders should not reduce the payout prospects of the continuing policyholders.

f) Investment policy

The Society operates a conservative investment policy as a result of its solvency position as measured under the ICA framework. The Society accordingly invests mainly in fixed-interest securities (both gilts and corporate bonds) and is unlikely to be able to alter this policy.

This strategy is helpful in reducing risk, and in helping to maintain solvency. It protects with-profits policyholders from the worst effects of falling stock markets, but also limits the returns that will be achieved in rising stock markets.

g) Exposure of with-profits policyholders to business risk

With-profits policyholders share in all the profits and losses of the Society. These are passed on through the Policy Value system. The Board aims to manage risk where possible to minimise any negative impacts on policy payouts and so that the Society can continue to be able to meet its contractual obligations to policyholders and other creditors as they fall due.

The Society's strategy in respect of business risks, some of which are outside the control of the Society, is to seek opportunities to reduce and/or limit the risks, whilst being fair to all policyholders.

There are limited circumstances in which the Society would accept new business risks, being either where it is satisfied that the rewards are sufficient and the risks are not high, or where the taking of a new (lower) risk would mitigate an existing business risk.

4. Bonus Policy

4.1 Principles

In determining bonus policy, the Society aims to balance the objectives of continuing to meet its obligations to policyholders and other creditors as they fall due and of distributing the Society's assets over the lifetime of its policies as fairly as possible. Consideration is given to the overall financial position of the Society which is affected by many things including, inter alia, investment returns and outlook, actual and expected expense levels, the expected cost of guarantees, miscellaneous profits and losses (including those from the non-profit business) and changes in the level of provisions. The rate at which surplus is distributed may vary depending on the Society's requirement for solvency capital, and the general level of uncertainty (for example, in the various provisions).

For the foreseeable future, any new distributions of surplus will be made in non-guaranteed form, and there is no expectation of any further reversionary bonus being awarded in the near to medium term. This applies across all product types and all territories. This approach aims to maximise the likelihood of the Society being able to meet all its future contractual liabilities.

The Society aims to set bonuses and payout levels which are fair across different groups and generations of policyholders. Profits and losses are typically shared across the whole of the with-profits business, not just among the policies concerned. For example, the cost of administration is shared across the whole of the with-profits business. Changes to Policy Values plus any Capital Distribution Amount and their equivalents, are often the same for all policies within a particular class, but it is possible that they will vary between different groups and generations of policyholders.

4.2 Practices

4.2.1 Setting the level of payouts

The sum of the Policy Value plus any Capital Distribution Amount and their equivalents will determine payouts.

4.2.1.1 Setting the level of Policy Values

The levels of Policy Values are kept under regular review, and the Board may change them at any time if circumstances require it, though efforts are made to avoid frequent changes. There is a more formal annual review process, and the levels of Policy Values are reset after that review. The results are usually announced as part of the Annual Report and Accounts, or via the Society's website. This review will often result in all Policy Values within a particular class being increased (or decreased) by a rate or rates determined by the Board. Different rates can apply to different policy classes where it is judged fair to do so (for example, applying a net of tax rate for life policies). The Board may at its discretion choose to vary the rates awarded according to other factors (such as age or term or level of guarantee) if this is judged to result in a fairer allocation.

An increase in Policy Values does not constitute an increase in guaranteed benefits and Policy Values can be reduced at any subsequent time.

The change in the level of individual Policy Values from year to year will depend, among other things, on the following factors:

- The expected sustainable long-term return that can be achieved on the with-profits fund.
- The Society's requirement to maintain an appropriate level of solvency capital.
- A deduction for expenses and tax (see section 4.2.2).
- A deduction to cover the expected cost of guarantees (see section 4.2.3)

The amounts required for the various deductions shown above will be a function of many variables, for example, prevailing economic conditions, regulation and the uncertainty surrounding the level of the provisions the Society has made (see section 8.2.3).

While the aim is to increase Policy Values in future, there is a possibility that they may be reduced, if there are material investment losses or if the Society's desired level of solvency capital increased.

The levels of solvency capital required and available for the Society are strongly influenced by “Total With-profits Policy Values” (the sum of the total Policy Values for RSP policies and the equivalent measures for other with-profits policies). It would generally be expected that Total With-profits Policy Values would be kept at such a level that the ratio of solvency capital to the level required by the regulator, as defined under the ICA framework, is in the range 130% to 250%. i.e. to maintain a reasonable margin over the minimum requirement. It would be unusual for Total With-profits Policy Values to be at a level such that the ratio is outside the range of 130% to 250%.

By allowing the ratio to vary within an appropriate range, the Society can achieve an amount of smoothing, and avoid changing Policy Values every time one of the elements noted above changes.

If the ratio fell below 130% , Policy Values are very likely to be reduced to restore solvency in line with the Society's requirement to maintain an appropriate level of solvency capital. Policy Values are likely to be increased if the ratio exceeded 250%.

4.2.1.2 Setting the level of Capital Distribution Amount

The level of the Capital Distribution Amount will be kept under regular review and is set so as to be as fair as possible to those policies leaving the with-profits fund and those remaining in it.

The change in the level of Capital Distribution Amount from year to year will depend, among other things, on the following factors:

- The amount of solvency capital available to be distributed;
- Any changes in the level of current or anticipated regulatory capital requirements;
- The level of uncertainty about and expected volatility of future investment conditions;
- The Board's requirement to maintain an appropriate level of solvency capital for remaining policyholders;
- The degree of smoothing the Board feels is appropriate.

The Society will review the appropriateness of the Capital Distribution Amount and reserves the right to vary or withdraw its use at any time without prior notice to policyholders.

4.2.2 Expenses and taxation

All of the expenses and taxation of the with-profits business falls to the with-profits policyholders, and directly reduces the amount available for distribution to with-profits policies. In addition, any profits and losses arising from expenses or tax on the rest of the business, that is not reassured, also flow through to with-profits policyholders.

Expenses and tax will typically be applied to with-profits policies by an appropriate deduction before altering Policy Values and their equivalents. This allows all with-profits policies to share in the expense performance, profits and losses, roughly in proportion to their share of the with-profits fund. The expense deduction is currently set at 1% per annum This approach will allow the costs of administration to be spread across different generations of policyholders fairly.

4.2.3 Charge for solvency capital and cost of guarantees

The Society expects to make a charge each year to provide solvency capital and to meet the expected cost of guarantees (i.e. the additional cost where a policy's guaranteed benefits exceed its Policy Value plus any Capital Distribution Amount, now or in the future). This means that a charge will typically be retained each year before making future increases to Policy Values and their equivalents.

For the short term at least, changes to Policy Values and their equivalents are expected to be net of a charge for solvency capital and cost of guarantees of 0.5% each year. This charge can be expected to increase if the cost of guarantees increases significantly (for example, as a result of adverse investment conditions), or solvency capital requirements increase. In contrast, the charge would reduce if the expected cost of guarantees reduces, as, for example, with the introduction of the Capital Distribution Amount.

The level of the charge for capital and cost of guarantees will be kept under regular review by the Board before deciding any changes to Policy Values, and their equivalents. If the expected charge exceeds 1.5% per annum, the change would be communicated to policyholders.

As an example, if the Society's future smoothed with-profits investment return after allowing for expenses and tax and allowing for other sources of profit and loss averaged 4.5% per annum, the increase to Policy Values, would be based on a return of 4.0% per annum after all charges including the 0.5% charge for capital and cost of guarantees. This example is not intended to convey any expectations about future investment returns.

4.2.4 The Society's requirement for solvency capital

In common with all other UK insurers, Equitable Life requires a certain amount of solvency capital to operate its business, to provide for risks and for the purpose of smoothing. This solvency capital is to meet statutory and ICA capital requirements. The key measure is defined within the Society's Annual Report and Accounts as the Excess Realistic Assets and is the amount available to meet any unforeseen liabilities and liabilities in excess of those already provided for at the balance sheet date and to enhance bonuses in the future.

The EU Commission is planning to introduce a new pan-European solvency regime (referred to as 'Solvency II') in 2013. This will require a different, and potentially higher, solvency capital requirement. The requirements of this new regime, as they are finalised, will also need to be considered but currently they are still subject to further clarification.

The Society has no wish to build up and retain excessive amounts of solvency capital because it will all ultimately be distributed. If the ratio described in 4.2.1.1 falls below the bottom of its target range, and/or if the amount of solvency capital required increases (possibly, for example, as a result of greater uncertainty around the level of the provisions, or more onerous regulatory requirements) Policy Values and Capital Distribution Amounts are very likely to be reduced to provide additional solvency capital. The opposite is also true in that if the ratio described in 4.2.1.1 rises above the top of the target range, then the Society is likely to distribute some of the surplus solvency capital by increasing Policy Values.

4.2.5 Interim bonus on policy termination

Though Policy Values can be changed at any time, the regular review cycle operates annually. The Board may at its discretion set an interim bonus rate each year, with the aim that the Policy Value plus any Capital Distribution Amount on any exiting RSP policy would be increased at that rate for any part year since the last annual review of Policy Values. Interim bonus rates are set by the Board, and are usually announced as part of the Annual Report and Accounts, or in the annual statements sent to policyholders. When setting any interim rate the Board will consider, inter alia, the desired level of solvency capital, and the outlook for future returns on the with-profits fund. The interim bonus rate does not increase the guaranteed benefits under a policy.

As for the other types of bonus, interim bonus rates may vary by policy class, and different rates can apply for different parts of the year. Subsequent changes to Policy Values plus any Capital Distribution Amount and their equivalents will not necessarily be at the rate implied by the interim bonus rate in force at the time.

4.2.6 Other with-profits business

Other with-profits policies do not have Policy Values, but the same principles and consistent practices are used to determine bonuses and payouts.

To determine payouts on maturity or death for other with-profits business, tables of final bonus rates are calculated by using representative policies with the aim of achieving a result comparable to similar RSP policies. Payouts are calculated by applying the relevant final bonus rate to the guaranteed benefits (including any reversionary bonus).

5. Smoothing

5.1 Principles

The Society has a preference that changes in levels of bonuses and payouts should be gradual whenever circumstances permit, and reflect the underlying trend of investment returns. However, in adverse scenarios, especially when investment returns are poor, there is limited scope for smoothing. In particular, smoothing considerations will be overridden by the Society's need to be able to meet its contractual obligations to policyholders and other creditors as they fall due and any solvency capital requirements that the Society may have.

The Society considers smoothing in the context of its reviews of Policy Values plus any Capital Distribution Amount, rather than comparing the payout value of one policy with an equivalent one taken out a year earlier. This principle has been established over many years. It helps to avoid the amount paid under a policy being unduly distorted by reference to the experience of the fund in the year before the policy commenced.

5.2 Practices

It is in the nature of with-profits policies that payouts are smoothed, and that there will be some cross-subsidies between policies. In stable conditions, the Board attempts to avoid sharp or frequent changes to the level of payouts but the capacity of the Society to smooth out experience is affected by the level of solvency capital it has. Therefore, in adverse scenarios, especially when investment returns are poor, payouts and Policy Values and their equivalents may be changed quickly to protect solvency.

When determining Policy Values and any Capital Distribution Amount, the Board considers all aspects of the Society's financial position. Particularly important inputs are the return achieved by the with-profits fund each year, the longer-term expectation of returns and also the expectations for the distribution of solvency capital. When considering the level of Policy Values, the Board may adjust the actual investment return achieved on the with-profits fund, in order to smooth out short-term effects.

If the level of Policy Values means that the ratio described in 4.2.1.1 moves below its target range, they are very likely to be reduced. Equally, appropriate action will be considered if the ratio is above the target range.

6. Payouts on early surrender

6.1 Principles

Where a policyholder surrenders his policy (or switches to a unit-linked fund) before maturity, contractual obligations in respect of payouts under the policy generally do not apply. The intention is that the amount paid to surrendering policies should be fair, but that it should not disadvantage continuing policyholders. In particular, the amounts paid to surrendering policyholders should not reduce the payout prospects of the continuing policyholders.

6.2 Practices

Payouts on policies which have been surrendered early (or where benefits are being switched from with-profits to unit-linked funds) are determined by reference to Policy Values plus any Capital Distribution Amount and their equivalents. The guaranteed benefit, explained in section 2.2 a), is only available on specified events such as retirement and death and does not apply on early surrender. The Policy Value plus any Capital Distribution Amount may be significantly less than the guaranteed benefit. Where appropriate, to avoid prejudice to remaining policyholders, the Society applies the Financial Adjustment to reduce the amount payable on surrender of the with-profits benefits. For example, if the Financial Adjustment on UK individual pension policies was 5% (as it has been since 24 April 2007), payouts on surrender would be 95% of the sum of the Policy Value plus any Capital Distribution Amount.

The Financial Adjustment does not apply to withdrawals of income from managed pension policies or to some regular withdrawals up to a certain amount on some life policies.

Different Financial Adjustments may apply for different classes of policy, for example, between life and pensions business, or between Individual and Group pension policies, or between policies denominated in different currencies. The rate could also vary within a class, if this was thought by the Board to improve fairness or provide a more effective means of protecting solvency as measured by the ICA framework. For RSP policies, the Financial Adjustment is currently applied as a percentage reduction, but alternative methods could be used. For example, if it was required in order to protect solvency, the Financial Adjustment could be calculated to produce surrender payouts equal to the discounted value of the guaranteed benefits.

The level of the Financial Adjustment depends on the overall financial position of the Society, and it can therefore be affected by many factors. The following considerations apply when determining the Financial Adjustment:

- The Financial Adjustment should be set at a level which enables the Society to maintain the level of solvency capital it requires as assessed by the Society's ICA or any anticipated equivalent regime (e.g. Solvency II). This may also be affected by any ICG given by the FSA - as described in section 3 b) above.
- Policyholders surrendering their policies early should also contribute toward the cost of guarantees for those policies remaining in force. It may also be appropriate to allow for the additional risk that in adverse circumstances in the future the cost of guarantees may increase significantly for policies with a GIR of 3.5% per annum.
- Those surrendering their with-profits benefits early or switching from with-profits to unit-linked funds should contribute their full share of the cost of provisions (including an allowance for the uncertainty associated with these).
- Large volumes of surrenders can cause forced sale of illiquid assets at impaired values. Any such losses will be recouped through the Financial Adjustment.
- Where the Society is forced to sell fixed-interest securities before their relevant maturity dates, in order to make payments to surrendering policyholders, the matching by term of assets and liabilities is broken. If this is to the disadvantage of continuing policyholders, the Society will recoup any value lost through a higher Financial Adjustment.
- If solvency is threatened, for example, by large volumes of early surrenders and switches from with-profits to unit-linked funds, the terms for exit will be set so that the solvency position is improved (or at least unaffected).
- Surrenders can cause diseconomies of scale in the operating costs of the Society, so a contribution to future anticipated expenses may also be allowed for in surrender values.

Similar considerations apply when setting surrender values for other with-profits policies.

7. Investment Policy

7.1 Principles

The Society operates a conservative investment policy as a result of its solvency position, as measured under the ICA framework. The Society accordingly invests mainly in fixed-interest securities (both gilts and corporate bonds) and is unlikely to be able to alter this policy.

This strategy is helpful in reducing risk, and in helping to maintain solvency. It shields with-profits policyholders from the worst effects of falling stock markets, but also limits the returns that will be achieved in rising stock markets.

7.2 Practices

7.2.1 Asset allocation and choice of asset holdings

The Society operates one with-profits fund. Apart from different arrangements for policies denominated in different currencies, the same asset allocation applies to all with-profits policyholders, including those with different underlying policy guarantees. Life assurance policies are subject to different tax rules from those applying to pension policies, and hence different bonus levels, but they share in the same underlying mix of assets.

The Society reserves the right to adopt different investment mixes for different groups of policyholder, or for the solvency capital of the Society, where this would be fair to the different groups and where it would be beneficial to the operation of the long-term fund as a whole. Such a change would require the approval of the Board.

The vast majority of the Society's assets are denominated in sterling. It is expected that the exposure to asset classes backing the sterling with-profits business will remain in the range shown in the table below, with equity and property investments falling to very low levels in the short to medium term.

Asset class	Range as a percentage of fund
Gilts and corporate bonds	75-90%
Property related investments	0-10%
Equity-type assets	0-15%
Cash	0-25%

7.2.2 Investment strategy and governance

Investment strategy is determined by the Board. The Executive Investment Committee, a committee of executive management, has delegated authority from the Board to oversee the implementation of that strategy. The Board judges the merit of current and alternative investment policies (having received advice from the Executive Investment Committee) and decides if new instructions should be passed on to the Executive Investment Committee. In deciding if investment policy should be amended, the Board considers whether such a change would strengthen the with-profits policyholders' position, by improving their potential payouts or reducing risks, without having a detrimental impact on the Society's ability to meet its regulatory obligations or its contractual obligations to other policyholders and creditors.

The Executive Investment Committee defines the investment objectives for the investment managers and the parameters within which the investment managers may manage the assets of the with-profits fund. Those instructions include:

- Details of a central benchmark and acceptable ranges (in percentage terms) for each main asset category.
- Details of cash flow matching requirements.
- Details of acceptable credit or liquidity quality.
- Limitations on investments in relation to counterparty exposure.
- Limitations on exposure in respect of derivatives and other instruments that may alter the economic out-turn from assets.

The Executive Investment Committee meets regularly to review investment performance and controls. Solvency and the desire to have a close match of asset and liability proceeds are key drivers of investment strategy, so it is kept under regular review, and reported formally to the Board at least every six months. A more thorough and formal review of the Society's financial position, the risks it faces, including investment risk and the solvency capital required, is carried out at least once a year, and is reported to the Board. Any changes to the investment strategy resulting from these reviews would be implemented by the Board or Executive Investment Committee.

7.2.3 Investment managers

The Society employs the services of specialist investment management companies to carry out its asset management. The Society's Executive Investment Committee oversees the activities of these providers on behalf of the Society. The Society regularly reviews the provision of its investment services.

The investment managers are required to report regularly on investment performance, to have appropriate controls in place to ensure compliance with the various benchmarks and objectives set by the Society and to report to the Executive Investment Committee where there are any breaches of these requirements.

The investment managers are expected to demonstrate to the Executive Investment Committee, as and when required, that processes are in place to ensure that the portfolios are being managed in an appropriate manner with respect to risk.

7.2.4 Asset types held in the with-profits fund

The following sections provide more detail about the different types of assets held in the with-profits fund.

a) Gilts and corporate bonds

Gilts provide the most certain future cash flows for the with-profits fund, and the guaranteed future income and maturity proceeds help the Society to match some of the guaranteed liabilities. Gilts are therefore a natural investment for the with-profits fund, and are expected to remain the core investment class.

Corporate bonds share many of the attributes of gilts, providing relatively predictable cash flows and relatively high income yields. The wide choice of corporate bonds, offering a wider spread of maturity dates than gilts, is helpful in improving the matching by term of assets and liabilities. Corporate bonds also offer the potential for modest outperformance compared with gilts, providing the with-profits fund with an opportunity to pass on slightly higher returns to policyholders. This upside potential comes with downside risk - the Society's investment policy is to limit this by regularly reviewing its bond holdings and ensuring that they are predominantly investment grade bonds.

b) Cash

The other main asset class is cash, including deposits and cash OEICs. The Society generally uses cash to fund day-to-day expenses, to provide sufficient liquidity to meet expected claims volumes and to meet any obligations in respect of derivative holdings. Cash may also be held in periods where changes to investment strategy are being considered or in periods of greater volatility in the markets.

c) Property

The Society currently holds a portfolio of property, some directly owned, and some indirectly. Property investment potentially offers some desirable characteristics, including a relatively high annual income on the direct holdings, and the potential for returns in excess of gilts. The upside potential on returns means that the property portfolio is one of the most important ways in which the Society might enhance its returns to with-profits policyholders.

There is a risk of capital depreciation and/or falls in rental income. This is limited by having a maximum level of permitted property investment, and further mitigated by maintaining a spread of property holdings. Liquidity risk is helped by having a broadly based portfolio. There are also indirect holdings that can be traded without having to sell the underlying property.

The property portfolio is regularly reviewed to ensure the nature and level of property investments are consistent with the solvency capital and liquidity requirements of the fund as it runs off.

d) Equity type assets

The Society's solvency position restricts the ability to hold a large portfolio of equities. Though the prospect of long-term outperformance from this asset class is attractive, the associated investment risks are considered to be unsustainable in high proportions.

The Society retains a portfolio of other equity-type assets comprising:

- Private equity funds.
- Investment trusts.
- Other alternative investments.

These types of assets are generally not actively traded. Much of the portfolio is invested in schemes with a defined end date, at which point the value of the underlying assets is shared between the stakeholders. The Society's general strategy is to keep these assets until maturity. However, if opportunities emerge to sell at an attractive price prior to maturity, the Society will do so if it is judged to be for the benefit of with-profits policyholders. With this strategy the holdings will remain a small part of the Society's total assets, for the next few years. Additional equity exposure may also be achieved by using derivatives. New equity investment will also be considered if the Board determines that the potential rewards of such investments, the increased risks applying and the additional solvency capital required are in the long-term interests of policyholders.

e) Derivatives

The Society's policy is that it would not expect to invest in any such asset as a speculative investment. It would, however, consider using derivative-based assets where these offered a cost-effective means of managing a specific risk (for example, to help manage interest rate risk, currency risk or improve cash flow matching), managing exposure to different asset classes or of smoothing out potential volatility in returns.

During 2007, the Society purchased a series of interest rate swaptions as part of a strategy to manage the combined risks of a low interest rate economy and policyholders deferring their retirement.

Late in 2009, the Society purchased currency futures to manage its exposure to dollar currency risk.

7.2.5 Overseas business

A small amount of business sold overseas is denominated in euros or dollars. This business is still part of the overall with-profits fund, and shares the same general risks. Investments have been made in assets that are denominated in the same currency, to limit currency risk.

7.2.6 Matching assets and liabilities by nature and term

An important aim in managing the investment portfolio is to achieve a close match in the term to expected maturity and nature of the assets and liabilities. Regular analyses are carried out to facilitate this. Matching by term and nature is important when prevailing interest rates (or yields) change. In that case, the market value of the assets changes, which can have implications for solvency.

An exact match by term and nature is not possible since property and equity investments have neither a fixed redemption date nor predetermined nature, but efforts are made to achieve a good match for the fixed-interest securities. The matching assumes that assets are held to maturity. If policy surrenders cause assets to be sold prior to maturity, the matching characteristics become unbalanced and the with-profits fund can be exposed to loss. Any loss in asset values will typically be charged to the surrendering policies through the Financial Adjustment, to protect remaining with-profits policyholders.

If the term of the liabilities changes for other reasons, for example, through policyholders deferring their retirement, the Society would typically expect to change the term of some of the assets to stay in line. As far as possible this would be done by appropriate investment of cash flows such as continuing premiums, investment income and redemption proceeds, to minimise costs. If any costs (or surplus) arose from rebalancing the assets in this way, they would be shared across the whole fund.

7.2.7 Other investment matters

The Society holds various provisions in respect of potential payments to other creditors. The assets backing those provisions are held as part of the with-profits fund, and implicitly comprise the same asset mix. The backing assets, being largely fixed-interest securities and cash, therefore provide a reasonably good level of matching.

The with-profits fund does not contain any investments that are non-tradable because of their importance to the Society. In particular, the head office premises are rented and are not held as an investment.

7.2.8 Asset mix backing the non-profit policies

The with-profits policyholders share in any profits and losses arising from the non-profit business. The non-profit business consists entirely of guaranteed liabilities, so warrants a tightly constrained investment mix. Accordingly, it is backed only by fixed-interest assets and a small amount of cash. The assets are chosen to provide a close match by term to the liabilities. Within the non-profit liabilities is a group of index-linked liabilities (mainly annuities). These are backed by separately hypothecated assets that are predominantly index linked to optimise the matching of assets and liabilities.

Though there are no property and equity assets backing the non-profit liabilities, some investment risk arises from the corporate bonds. These investments are subject to similar considerations, for the with-profits fund as described earlier, namely, that the securities within the portfolio are overwhelmingly investment grade, and comprise a broad range of holdings intended to avoid overexposure to individual issues/companies.

8. Business Risks

8.1 Principles

With-profits policyholders share in all the profits and losses of the Society. These are passed on through the Policy Value system. The Board aims to manage risk where possible to minimise any negative impacts on policy payouts and so that the Society can continue to be able to meet its contractual obligations to policyholders and other creditors as they fall due.

The Society's strategy in respect of business risks, some of which are outside the control of the Society, is to seek opportunities to reduce and/or limit the risks, whilst being fair to all policyholders.

There are limited circumstances in which the Society would accept new business risks, being either where it is satisfied that the rewards are sufficient and the risks are not high, or where the taking of a new (lower) risk would mitigate an existing business risk.

8.2 Practices

8.2.1 Corporate governance

The Society aims to meet the highest standards in corporate governance and has voluntarily adopted the relevant provisions of the Principles of Good Corporate Governance and Code of Best Practice ("the Combined Code"), applicable to public companies, since its issue in 1998. In July 2005, the annotated Combined Code for mutual insurers was published by the Association of Mutual Insurers and the relevant provisions of this have been adopted by the Society.

The Board is ultimately responsible for the management of the Society and the operation of its business. A number of responsibilities are delegated by the Board, for example, to the Chief Executive to implement strategy and manage the Society and to the Executive Investment Committee to determine investment policy and monitor investment performance. The Directors are ultimately responsible for the Society's system of internal control and for reviewing its effectiveness. The Society operates a number of control procedures to safeguard its business and investments.

Payouts on policies, bonus policy, capital distribution and smoothing are determined by the Board. The With-profits Actuary provides advice to the Board on these and other matters affecting the Society's life insurance business.

In assessing a business risk the Board of the Society evaluates the potential impact and likelihood of any outcome for the risk. The factors considered when evaluating the risk impact include (but are not restricted to) financial and solvency, regulatory (including ICA and any applicable ICG), reputational, client service issues and other operational risks.

8.2.2 Business risks environment

There are a large number of parties who have the ability to affect the environment in which the Society operates. These include policyholders, parliament, regulators, outsourcing and other suppliers, action groups, litigants and the media.

Life insurance business is subject to a number of inherent risks that arise from a range of factors, which include interest rate changes, fluctuations in asset values and demographic changes.

The Society is exposed to particular risks resulting from its past business operations, particularly relating to risks resulting from the relatively high proportion of guaranteed liabilities and risks relating to control of expenses of administration. Moreover, the Society faces uncertainty relating to the level of its provisions for pension schemes and other risks and there exists the possibility of further litigation being brought against the Society, which is discussed below.

Any financial gains or losses arising from business risks are attributable to the Society's with-profits policyholders.

8.2.3 Contingent liabilities and uncertainties

The following passage is extracted from Note 22 of the Annual Report and Accounts for the year ended 31 December 2010, which may be found on the Society's website (www.equitable.co.uk)

22. Contingent liabilities, uncertainties and other risks

There exist some uncertainties that, if they were to materialise, could adversely impact on the financial position of the Society. Over the last few years, these uncertainties have been addressed to a very significant extent, and the range of possible outcomes has continued to narrow.

The major development during 2010 was Government's announcement of a payment scheme in response to the Parliamentary Ombudsman's report into the regulatory handling of the Society. In contrast, there was little change in respect of the 91 claims against the Society in district courts across Germany where the cases have all been defended successfully so far. Also outstanding are investigations initiated by the Accountancy and Actuarial Disciplinary Board ("AADB"). The AADB are investigating an accountant and an actuary in respect of the provision of information for use by the Financial Reporting Review Panel relating to the financial statements of Equitable Life in 1999. The actuary is also being investigated by the AADB in relation to audits of the 1997, 1998 and 1999 financial statements. The AADB is also investigating the conduct of certain actuaries in relation to the provision of advice by, or on behalf of, the Government Actuary's Department to prudential regulators.

It is not considered that the uncertainties described above represent a significant financial threat, and it is considered that the risk of any material new issues arising for the Society appears limited.

The Board continues to closely monitor the contractual commitments the Society has in respect of the two pension schemes for which HBOS is principal employer, as set down in Note 8c to the financial statements. There remains a possibility that it may be necessary for a more conservative basis to be adopted in future in calculating the Society's obligations.

Additionally, there remains a risk to the Society that investment conditions change or policyholders defer their retirement, which may materially alter the calculations of technical provisions for policy liabilities.

The process of transferring administration services back to the Society brings with it a range of operational risks, which makes the estimation of future costs more uncertain, and will require careful management. The Society has arrangements in place for identifying, monitoring and managing these risks.

The financial position of the Society has been projected under a range of economic scenarios, in order to assess how robust it remains in adverse conditions. The projections make allowance for capital distribution. The Board has also considered the level of contingent liabilities in its analysis of the Society's financial position and considers that these have reduced in significance in recent years. Based on these analyses, the Board is confident of its ability to manage adverse scenarios that may arise, recognising that in some scenarios very strong action to reduce policyholder payouts would be required.

The Board has assessed these uncertainties using the latest available information and has concluded that it is appropriate to prepare these financial statements on a going concern basis.

8.2.4 Other business risks

Other business risks which may affect the environment in which the Society operates are noted below. The list is not exhaustive, but aims to highlight the more important issues.

a) Cost of guarantees

For some of the Society's policies, the guaranteed benefits will be higher than the Policy Value plus any Capital Distribution Amount at maturity. If so, the higher guaranteed amount is payable. This extra amount is known as the cost of guarantees. When considering the level of payouts, the Board will take account of the cost of guarantees. This cost is a complicated function of many different factors - most notably interest rates, persistency and the ages at which policyholders decide to retire. These factors are not within the Society's control, so there are adverse scenarios where the cost of guarantees can increase. Any such increase will need to be met from solvency capital, and/or charges against the level of future payouts. This could mean having to vary the charge for capital and guarantees (as noted in section 4.2.3).

b) Mortality

The Society retains a small portfolio of non-profit annuities in payment. A small number of new policies are written when existing policyholders purchase an annuity with the proceeds of their retirement policy.

The Society has set up reserves to fund the expected future liabilities, under the annuities which it has issued, based on an assessment of likely future longevity. That assessment is based on the Society's actual recent experience, and allows for continued improvements in future expected lifespan, based on industry research. If actual experience deviates from the basis assumed, the resulting profit or loss will fall to the with-profits policyholders.

c) Administration services and expenses

Following a review of the Society's administration services, the Society decided to take in-house the provision of these services in 2011. Until then, the services will continue to be provided by a subsidiary undertaking of Lloyds Banking Group.

The with-profits policyholders bear all the Society's profits and losses arising from expenses. Expenses (and taxation) are deducted directly from the with-profits fund, and changes to the level of Policy Values are made after allowing for those deductions. The control of operating costs, including outsourced operations, is a key business risk.

As there is only one with-profits fund, there is no apportionment of expenses, and expense risk is pooled across all with-profits policies.

The Society has provided for significant levels of regular and exceptional non-recurring costs.

d) Reassurance

The Society's principal reinsurance agreement relates to its unit-linked and non-profit business (excluding certain non-profit immediate annuities and the mortality risk associated with unit-linked annuities), under which Halifax Life Limited is the reinsurer. The profits and losses associated with this business are also reassured.

Under the terms of the reinsurance contract, if the Society is insolvent, or is reasonably likely to become insolvent in the opinion of the reinsurer's Head of Actuarial Function, the reinsurer can make claims payments directly to policyholders whose benefits have been reassured. If Halifax Life Limited were to become insolvent the with-profits policyholders would bear any loss arising from the event.

Some group schemes have members with benefits that are invested in the Clerical Medical Investment Group With-Profits Fund via another reinsurance agreement. The Principles and Practices of Financial Management issued by the Clerical Medical Investment Group apply to these benefits and any additional premiums paid into this fund.

e) New business

The Society is closed to new business. The only 'new' business being written is where there is a regulatory or contractual requirement to do so in connection with existing policies, for example, allowing for deferred annuity policies to effect an annuity on retirement. Additional premiums are also accepted under existing policies in accordance with contractual policy terms. The amount of these additional premiums is very small relative to the size of the fund.

Where annuities are effected on retirement, they have been priced prudently so that, on the balance of probabilities, they would be expected to generate modest profits for the with-profits fund. The Society generally encourages people to purchase their annuities with another provider, as better terms will normally be available on the open market.

f) Run-off of the fund

The with-profits fund is expected to decline in size as policy payouts are made. In setting Policy Values plus any Capital Distribution Amounts and their equivalents the aim is to achieve a controlled and fair run-off of the fund, avoiding a 'tontine effect' where the policies that leave in the later stages of the fund's life do disproportionately well or badly.

In calculating Policy Values plus any Capital Distribution Amounts and their equivalents, the Society has already made allowance, as best it can, for the risks detailed above, so that they are shared by all current with-profits policies, not just those with the longest term to run. To the extent that the allowances are not matched by experience, the resulting profits and losses will fall to the with-profits policies in force at the time. These variances will be charged or credited as they are identified, without waiting for them to actually accrue, for example, if expected levels of life expectancy change, the effect of the change will be provided for immediately. This approach helps avoid all of the profits or losses being loaded on to the last remaining policies.

The Society will continue to consider the fairest way to distribute all of its assets to its with-profits policyholders.

Appendix

Overall rates of return - UK RSP policies (% p.a.)

Calendar year	Life (bonds)	Life (other contracts)	Pensions ⁽¹⁾
1989	16.50%	16.50%	20.00%
1990	11.50%	11.50%	12.00%
1991	11.50%	11.50%	12.00%
1992 ⁽²⁾	8.00%	8.00%	10.00%
1993	10.25%	10.25%	13.00%
1994	8.00%	8.00%	10.00%
1995	8.00%	8.00%	10.00%
1996	8.25%	8.00%	10.00%
1997	11.00%	10.75%	13.00%
1998	8.50%	8.50%	10.00%
1999	10.25%	10.25%	12.00%
2000 ⁽³⁾	0.00% / 6.75%	0.00% / 6.75%	0.00% / 8.00%
2001 ⁽⁴⁾	0.00% / 3.25%	0.00% / 3.25%	0.00% / 4.00%
2002 ⁽⁵⁾	0.00%	0.00%	0.00%
2003	1.50%	1.50%	2.00%
2004	2.80%	2.80%	3.50%
2005	3.60%	3.60%	4.50%
2006	4.00%	4.00%	5.00%
2007	4.00%	4.00%	5.00%
2008 ⁽⁶⁾	0.00%	0.00%	0.00%
2009	4.4%	4.4%	5.5%
2010	0.00%	0.00%	0.00%

Notes:

- (1) The bonus rates for pensions do not include those for Equitable 2000 Personal Pension Plans which are 0.4% p.a. lower than the rates shown for pensions contracts, except in 2002, and for parts of 2000 and 2001 (see notes 3 and 4), when the rate was 0.0%.
- (2) The rate described in the table applied to benefits purchased up to 31 December 1991. The rate for benefits purchased in 1992 was 9.5% p.a. for life contracts and 12% p.a. for pension contracts.
- (3) The overall rate for the first seven months of 2000 was 0% p.a. The rate for the remaining five months was 6.75% p.a. for life contracts, 8% p.a. for pension contracts and 7.6% p.a. for Equitable 2000 personal pension plans.
- (4) Policy Values as at 31 December 2000 were reduced by 14% and 16% for UK RSP life business and RSP pension business respectively, and those resultant Policy Values as at 31 December 2000 were used as the basis for calculating Policy Values on 16 July 2001 and on subsequent valuation dates. The overall rate for the first six months of 2001 was 0% p.a. The rate for the remaining six months was 3.25% p.a. for life contracts, 4% p.a. for pension contracts, and 3.6% p.a. for Equitable 2000 Personal Pension Plans.
- (5) Policy Values as at 31 December 2001 were reduced by 9% and 10% for UK RSP life business and RSP pension business respectively, and those resultant Policy Values as at 31 December 2001 were used as the basis for calculating Policy Values on 1 July 2002 and on subsequent valuation dates.
- (6) Policy Values as at 31 December 2007 were reduced by 2.4% and 3.0% for UK RSP life business and RSP pension business respectively, and those resultant Policy Values as at 31 December 2007 were used as the basis for calculating Policy Values on 31 December 2008 and subsequently.