ZURICH

Zurich Assurance Ltd

Principles and Practices of Financial Management – 2018 Annual Compliance Report to 90:10 With-Profits Fund Policyholders

4 April 2019

INTRODUCTION: This report tells you how we have managed the 90:10 With-Profits Fund ("the fund") in 2018. It explains how we have used our discretion in managing the fund. It also gives information about the fund's investments and the returns the fund has earned from them.

We manage the fund in line with our published Principles and Practices of Financial Management – our PPFM, or rulebook. The PPFM plays an important role in the governance of with-profits business and in ensuring the fair treatment of our customers. The PPFM focuses on the standards, methods and controls we use to ensure we run the fund fairly. It also explains how we respond to changes in the economic environment. When reading this report, you may wish to refer to the PPFM for definitions of technical terms.

A new version of the PPFM took effect from 30 April 2017 which is on our website: **www.zurich.co.uk/with-profits.** No changes to the PPFM were made during 2018.

The 90:10 Fund does not accept new business, with the exception of contractual increases, switches and other options that it is obliged to accept under the terms of existing policies.

The Board of Zurich Assurance Ltd (ZAL) has considered the matters covered in this report and the evidence presented to them by the With-Profits Actuary, together with advice from the Independent Person. The Directors' opinion is that, during 2018;

- the company has complied with the PPFM;
- the way the company exercised discretion was appropriate; and
- the company has addressed any competing or conflicting rights, interests or expectations in a reasonable and proportionate manner.

This report provides information in support of that opinion.

ENSURING FAIRNESS IN WITH-PROFITS: Our aim is to achieve fairness between different types and groups of with-profits policyholders, and between them and our shareholders. We believe fairness is achieved by:

- Making sure that we pay at least the guaranteed minimum payments when they apply.
- Aiming to pay out a fair share of investment performance to each with-profits policyholder (or any guaranteed amount, if higher). We use smoothed asset shares as a measure of the fair share for each contract. Appendix B of the PPFM describes the calculation of asset shares.
- By ensuring the mix of investments is appropriate to protect the benefits already added to plans.

- Where appropriate, aiming to achieve growth over the long term by having a proportion of the investments in higher-risk assets such as company shares and property investments, whilst ensuring that we can meet the fund's guarantees.
- Aiming to smooth through some of the peaks and troughs of stock market values.
- Adding regular bonus. We have to bear in mind that, where guarantees apply, we cannot take away regular bonuses once we have added them to your investment; and
- By setting final bonus rates for groups of plans rather than individual plans. We believe that the grouping of plans, and the cross-subsidies which result, are fundamental to the management of this type of with-profits business.

INVESTMENT STRATEGY: The assets of the fund are invested with the aim of:

- Achieving above average returns in the longer term relative to agreed market indices; and
- Making sure that the fund can always meet its guarantees

Hong Kong and Isle of Man administered business have separate asset pools and are allocated the investment return on those asset pools. The majority of the fund, including all UK and Malta business, has two distinct asset pools, one for life plans, unitised pension plans and Esitran plans, and a different pool for other types of conventional pension plans and assets backing guarantees and the Estate. Details of the investment performance and strategy for these two asset pools are shown below.

a) Life plans, Unitised pension plans and Esitran plans

This asset pool produced an overall investment return in 2018 of 0.5% for pension plans before charges (and 0.6% for life plans). The return for life plans is higher than the return for pension plans due to tax relief on investment losses on life business. This performance was below our long-term expectations due to lower returns on equities and fixed interest investments, partially offset by higher returns on property investments.

The percentage invested in equities and properties ranged between 26.4% and 29.5% during 2018. We expect the percentage invested in equities and properties to remain between 26.5% and 29.5% for the time being. During the final quarter of 2018 the percentage invested in equities was below this range for a short period as a result of investment losses on equities. The rest of the fund is invested in fixed interest and variable yield securities and cash.

During 2018, the fund purchased a series of options to protect it from significant falls in equity values. These options are types of derivatives, and as equity values fell during the year, holding these derivatives impacted the return to the fund by less than 0.1%.

We did not make any changes to the investment strategy in 2018 but we will keep the mix of assets and share options under review. Any proposals to significantly change the investment strategy for the fund require Board approval.

b) Conventional pension plans other than Esitran and assets backing guarantees and the Estate

This asset pool is currently invested entirely in fixed and variable interest rate securities and cash. In 2018 it produced an overall investment return of 0.6% before charges. This performance was below our long-term expectations due to lower returns on fixed interest investments.

To compensate for the lower expected long term returns of this strategy, ZAL currently adds a further 1% to asset shares each year. This enhancement is provided by the estate of the fund and may be revised or removed for future years.

We did not make any changes to the investment strategy in 2018 but we will keep the mix of assets under review. Any proposals to significantly change the investment strategy for the fund require Board approval.

ANNUAL BONUSES: The size of the regular bonus depends mainly on what bonuses we have already added, on past investment performance and on what we expect in the future.

We have to bear in mind that, where guarantees apply, we cannot take away regular bonuses once we have added them to your investment. This means that we may set the rate lower than we otherwise might do, and for some plan types the regular bonus rates is currently zero. If we didn’t set rates this way the guarantees in the fund could become big enough to force us to increase the percentage of the fund’s assets invested in lower risk assets such as government securities. Changing the fund’s assets in this way would mean we would expect to achieve a lower total return on your investment over the long term, even though the guaranteed part of the return on your investments that comes from regular bonuses might be higher.

In January 2018 we declared unchanged rates of annual bonus.

FINAL BONUSES: For each type of conventional pension plan other than Esitran the sum of the guaranteed minimum benefits for the plans which were expected to end in 2018 were larger than the sum of their asset shares. As a result no final bonus was declared. During 2018 we continued our established practice of deriving surrender values by recalculating benefit values from inception. This method also resulted in surrender values which were in excess of 100% of asset share on average.

For all other plan types, including Esitran, the full profits earned over the plans’ lifetimes will normally exceed the amount that has been added through annual bonuses. We therefore use final bonuses to ‘top up’ payouts so policyholders will also benefit from the rest of those profits. Investment returns will usually be the most significant source of profit but other sources, for example mortality or expense profits, can also affect final bonus rates.

If you take money out of the fund we may need to make a market value reduction (MVR). An MVR would only apply if the benefit value for the group of plans which includes your plan would be worth more than their fair share of the fund. The MVR would have the effect of reducing the amount paid out, so that it was more in line with the fair share of the group. We guarantee that an MVR will not apply on death, or on the future date on which you have previously asked for your plan to end.

Final bonus MVR rates depend on when the investment was made. This helps ensure that performance is shared fairly between groups of plans starting at different times, as these plans will have experienced different investment returns over their lifetimes. Our final bonus rates and MVR rates have been kept under review, and are changed in line with our published policy. To reduce the impact of fluctuations in investment values, smoothing is applied when calculating final bonus and MVR rates. We normally change rates once a year, although we may change rates more frequently if it's necessary to prevent unfair customer outcomes. Changing bonus rates relatively infrequently is a type of smoothing which reduces the impact of fluctuations in investment values. Smoothing may also be applied by limiting the change in plan values from one year to the next. Final bonus rates were changed on 8 January 2018 and rates were next changed on 14 January 2019.

During 2018, for each conventional plan type, final bonuses were set to target an average payout of 100% of asset share at maturity for each group of plans (except for Esitran plans – see the PPFM for further details). The minimum number of plans in a group was those plans or plan increases which commenced in a particular calendar year and were due to mature in 2018. Where the number of plans in a group was small we combined results for more than one commencement year. As the number of contracts surrendering is small, surrender values were set to target an average payout of 100% of asset share for the plan type as a whole. The same final bonus rates are used for death claims as for maturities.

For each unit series the final bonus rate was set to target an average payout of 100% of asset share. No MVRs were applied to any withdrawals during the year.

DISTRIBUTION OF EXCESS ESTATE: The Estate is the assets held by the fund in excess of those required to pay the expected liabilities of the fund. At least once a year we determine if the Estate is more than is needed to meet the aims of the prudent management of the fund.

During 2018, we continued to distribute the Estate to customers using the final bonus mechanism described in the PPFM. This distribution is achieved by considering whether to include an enhancement within asset shares at the time of claim. An enhancement of

16% of asset share applied to withdrawals during 2018 before 8 January 2018. For all other withdrawals in 2018 the enhancement rate was 25% of asset share. We reserve the right to exclude any new investment into the fund made after 1 April 2009. The enhancement can be altered or removed at any time.

TARGET RANGES: We aim for at least 90% of maturity payments to be within the range 80% to 120% of unsmoothed asset share and for at least 90% of surrender payments to be within the range 80% to 130% of unsmoothed asset share. During 2018 we met these targets as 93% of maturities and 93% of surrenders were within the target range. Maturity or surrender payments where a guaranteed amount is paid, causing the payment to fall outside the target range, are excluded from this assessment.

These ranges are similar to those used for many with-profits funds and narrower than those used by some. We believe that ranges of this size are appropriate for the 90:10 Fund because bonus rates are determined by considering all sources of profit and loss of the fund, and also because bonus rates are determined for groups of plans rather than individually.

Due to the long history of the fund and the extent to which contracts have been altered over time, we expect a small number of payments to be above or below the target ranges. When this happens we investigate the circumstances to ensure that neither customers leaving the fund nor those remaining within the fund have been treated unfairly. No evidence of unfair treatment has been identified so far but we remain vigilant and if unfair treatment were to be identified then appropriate action would be taken.

EXPENSES AND CHARGES:

a) Impact on policy asset shares. For plans in the 90:10 Fund, costs of administration and investment management are generally not applied as specific charges defined in the plan structures. Instead these costs are deducted from asset shares and so affect each plan's benefits to the extent that asset shares are used to calculate benefits. The costs of providing risk benefits, such as life cover, are charged to asset shares based on the estimated average cost over groups of similar plans.

On-going expenses are charged to asset shares in line with any charges identified in the contract. For Unitised With-Profits business any remaining expenses and commission are charged as a proportion of asset shares subject to a maximum of 2% per annum. For conventional with-profits business claims expenses are charged to the asset shares of plans becoming claims in the year, other remaining expenses are charged as a proportion of sums assured.

b) **Impact on the fund as a whole.** As a result of a scheme of arrangement effective 1 January 2005, investment management fees for all business together with administration expenses for Group business continue to be charged to the fund as incurred. For 2018 the charges to cover administration expenses for all other business are on a fixed rate basis and have increased in line with the Average Weekly Earnings Index for June. This resulted in an increase of 2.8%. The charges allocated to the fund are deducted from asset shares.

This arrangement protects the fund from increases which may result from diseconomies of scale that can sometimes occur in a closed fund situation.

The charges taken from the fund vary with different groups of plans and after the increase remain on average less than 0.5% of the fund's value. Future changes to the fixed rates are limited to the change in the Average Weekly Earnings Index for June each year.

The costs of certain other guaranteed benefits are met by the resources in excess of asset shares of the 90:10 Fund. Examples of guaranteed benefits are guaranteed annuity options and guaranteed maturity values.

COMMUNICATION TO POLICYHOLDERS: Two communications were made available to policyholders during 2018:

- An annual statement, which includes information on the with-profits fund. For unitised plans this is usually mailed close to the policy anniversary. For conventional plans the annual mailing was carried out in February 2018; and.
- In June 2018 we published the annual report on compliance with the PPFM on the ZAL website. That was the 2017 version of this report.

ENSURING FAIR TREATMENT OF CUSTOMERS: There are four main controls in place to ensure that customers in the fund are treated fairly:

- The scrutiny provided by our With-Profits Governance. The Board of ZAL is responsible for managing the with-profits business including setting bonus rates. A broad description of the Board's governance role is set out in Section 11 of the PPFM.
- Whenever we make important choices that affect the way we manage our with-profits plans, our With-Profits Actuary, who advises the Board, presents a report for the Directors giving the reasons behind the proposals and how these comply with the PPFM. The Board has appointed Martin Godwin as With-Profits Actuary.
- To support the Board and the With-Profits Actuary in these roles, ZAL has established a With-Profits Oversight Group which oversees management of the with-profits funds and the associated customer propositions, and ensures that the funds are properly controlled and managed.

- Throughout the year, all the data, work and actions that support our decisions have been recorded. The With-Profits Actuary has reviewed this evidence and has provided, below, his own opinion on this report.
- The Board also receives an independent assessment of compliance with the PPFM and how any competing or conflicting rights and interests of policyholders and shareholders have been addressed. The Board has appointed Steve Dixon as its Independent Person.

STATEMENT FROM THE WITH-PROFITS ACTUARY

2018 Annual Report from the With-Profits Actuary to 90:10 Fund Policyholders

In my opinion, the annual report from ZAL and the discretion exercised by ZAL during 2018 has taken into account the interests of the different categories of with-profits policyholders in a reasonable and proportionate manner.

I have formed this opinion based on the information and explanations given to me by ZAL, and taking into account the relevant rules and guidance issued by the Financial Conduct Authority.

My report, and the work on which it is based, complies with the technical actuarial standards issued by the Financial Reporting Council and the professional standards issued by the Institute and Faculty of Actuaries.

Martin Godwin

With-Profits Actuary

Zurich Assurance Ltd

4 April 2019