REPORT TO SCOTTISH WIDOWS WITH-PROFITS POLICYHOLDERS

REPORT ON PRINCIPLES AND PRACTICES
OF FINANCIAL MANAGEMENT (PPFM) FOR 2016

SCOTTISH WIDOWS

THIS ANNUAL REPORT TELLS YOU HOW WE HAVE MANAGED THE SCOTTISH WIDOWS WITH PROFITS FUND IN 2016. IT EXPLAINS HOW WE HAVE USED OUR DISCRETION IN MANAGING THE FUND, AND GIVES INFORMATION ABOUT THE FUND'S INVESTMENTS AND THE RETURNS THE FUND HAS EARNED FROM THEM.

Your policy is invested in the Scottish Widows With Profits Fund, held within Scottish Widows Limited.

We have managed the With Profits Fund in line with our published principles and practices – our PPFM. The PPFM focuses in detail on the standards, methods and controls we use to ensure we run with-profits fairly. It also explains how we respond to changes in the economic environment. You may find it helpful to refer to 'Your guide to with-profits', which summarises how we manage with-profits policies. We provided a copy of that guide to all customers owning with-profits policies in 2006. The current versions are also available on our website (www.scottishwidows.co.uk/wpguide).

If you have any further questions please contact us on 0345 845 0845.

The Board of Scottish Widows Limited met on 23rd March 2016 to consider the matters covered in this report and the evidence presented to them by the With-Profits Actuary, together with advice from the independent With-Profits Committee. The Directors are satisfied that the Scottish Widows With Profits Fund has been managed in accordance with the PPFM in all material respects.

The Directors of Scottish Widows Limited
23rd March 2017

1. OUR AIM

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 when guaranteed minimum payments apply we pay at least those amounts to policyholders.
- By aiming to make payments to with-profits policyholders that reflect their fair shares of the assets underlying their policies (or any guaranteed amount, if higher).
- By making investment decisions that give the Scottish Widows With Profits Fund the potential to benefit from the higher rates of return we expect to be available from some types of asset in the long term, for instance shares and property. Recognising that these assets can sometimes do less well in the short term, more secure investments are also held to safeguard the financial security of the fund.
- By cushioning with-profits policyholders from temporary stock market turbulence by "smoothing" payouts when policies mature or are surrendered; and
- By increasing the minimum guaranteed amount that policyholders will receive when their policies mature, by adding regular bonus – if we can do this without too great a risk to the financial strength of the fund and its freedom to invest in a range of assets for the long-term benefit of the fund.

2. THE SCOTTISH WIDOWS WITH PROFITS FUND IN 2016

2.1. Investment returns over 2016

Over 2016 investment markets provided strong returns for sterling-based investors. Company shares (equities) performed well across all major geographic regions. Initially this was due to further reductions in interest rates which made equities attractive relative to interest-paying assets. More recently equities rose in expectation of greater fiscal stimulus from the new US administration boosting economic growth. The FTSE-All Share index rose by around 17% (after allowing for investment income).

Sterling fell significantly against most major currencies during 2016 as a result of uncertainty over the impact of the EU referendum result. This enhanced the return on non-sterling assets and boosted the sterling value of UK companies' overseas earnings. Emerging Markets posted the highest equity returns due to improved investor sentiment and improvements in commodity prices.

Fixed interest bonds issued by the UK Government and by companies delivered moderate returns, including the income generated. Market performance over the first nine months of the year was partially reversed during the final quarter as growth and inflationary expectations increased, making fixed interest assets less attractive relative to other asset classes. The Bloomberg Barclays Global Aggregate Corporate Bond index grew by around 4% over 2016.

UK commercial property investments also produced moderate returns over 2016 as uncertainty over the impact of the EU referendum result on London's leading financial centre status offset the continued attractiveness of property investments in a low interest rate environment. The IPD UK Monthly Property Index rose by around 3% over the year (after allowing for rental income).

Absolute Return funds, which aim to make a positive return regardless of market conditions, provided low, but positive, returns during 2016.

Against this background, of strong performance from equities but more moderate returns from other asset classes, the Scottish Widows With Profits Fund produced an overall investment return on assets backing policies of 10% in 2016.

2.2. Investment policy

We choose the mix of assets with the aim of:

- getting the best possible long-term performance; and
- making sure that the with-profits fund can always meet its guarantees.

The need to meet guarantees means that we take account of the possibility of poor market conditions when we decide how much of the fund to invest in the riskier assets that offer the potential for better long-term returns. The current strength of the Scottish Widows With Profits Fund means we can hold a significant part of the fund in investments such as company shares and property that have the potential to perform well (but can be more volatile in the shorter term).

The rest of the fund is invested in lower-risk investments such as fixed-interest bonds. These include highly secure bonds issued by the UK Government, and others issued by companies that carry some risk but offer the opportunity for higher returns.

The Board reviews the strategic mix of different types of asset regularly. In 2016 we:

- Reduced our allocation to property investments. This continued a strategy introduced in 2015 to take advantage of the strong valuations at which properties in the fund could be sold. Part of the sales proceeds were subsequently reinvested in property assets when suitable opportunities arose.
- Reduced the fund's exposure to UK equities in favour of Emerging Market equities. This continued the policy adopted towards the end of 2015 when Emerging Markets were identified as offering better value than Developed Markets.
- Continued to have only a relatively small proportion of the fund invested in UK government bonds based on their valuation being well above historical levels i.e. yields being historically low. As a result of this decision, a higher proportion of the fund is invested in cash deposits than normal.
- Changed the geographical mix of company shares held by increasing investment in European and Japanese Equity markets, while reducing US and UK allocations, as this was expected to generate higher returns for the fund.

We expect these changes to increase the fund's returns over the medium term.

We allow our investment managers to vary from the strategic mix selected by the Board, based on the managers' views of how different types of asset and regions will perform in the shorter-term.

The mix of investments backing policies is shown below. The changes over the year reflect the combined effect of:

- The strategy changes described above.
- Changes in the shorter-term positioning taken by the investment managers, which at the end of 2016 included an increase in UK Government Bonds (albeit to a low proportion of the fund compared to historic allocations to this asset class) and a decrease in allocation to Corporate bonds (fixed interest bonds issued by companies) and Property.
- The relative movement in different markets (a strongly performing type of asset will tend to increase as a proportion of the fund naturally). Equities performed particularly well in 2016, especially Emerging Markets.

Asset Allocation	31st Dec 2014	31st Dec 2015	31st Dec 2016
Fixed interest			
• UK government bonds	5%	2%	5%
• Corporate bonds	16%	14%	12%
Loans secured against commercial property	0%	3%	4%
Property	14%	14%	10%
Equity shares			
• UK shares	20%	20%	19%
• Non-UK shares	26%	23%	29%
Absolute Return funds*	7%	12%	12%
Other investments (mainly cash deposits)	12%	12%	9%

* Absolute Return funds aim to make a positive return regardless of market conditions.

Different percentages apply to our Flexible Options Bond and Pensionplanner policies. These can be found in the Asset Mix part of our with-profits website.

Some pension policies contain valuable options to convert the payout from the policy into a pension at guaranteed terms. The cost to the Scottish Widows With Profits Fund of honouring these options is affected by market interest rates. To protect the fund from changes in market interest rates the fund holds specially constructed investments. These investments rise and fall in value to a similar extent that the options rise and fall as market interest rates change. These investments are held separately, in the Additional Account, and are not included in the assets shown in the table above. The Additional Account was set up at demutualisation, in 2000, to meet costs such as these options. It will be used to enhance final bonuses to the extent it is not needed for these other costs.

2.3. Regular bonuses

The size of the regular bonus depends mainly on what bonuses we have already added to policies, past investment performance and what we expect in the future. When setting a rate of regular bonus we consider all the policies that receive that bonus and not each policy by itself.

We aim to set the rate of regular bonus so that the guarantees do not become too large relative to the relevant assets of the fund. If we were to set rates of regular bonus at higher levels, we'd restrict our investment freedom and have to invest more of the with-profits fund in more predictable lower-risk assets (such as cash or government bonds). We would then expect to have less to pay out to policyholders in future years.

The majority of regular bonus rates were unchanged through 2016 but at the end of the year we reduced the rates that apply to unitised with-profits policies (from 2.5% to 1.75% per annum for the largest product group). This reflects lower assumed future investment returns, following significant falls in yields on low risk investments such as Government Bonds. Regular bonus is only part of a policy's payout and final bonus may be added whether or not we are currently adding regular bonus to a policy (please see section 2.4).

2.4. Payouts in 2016 – final bonuses and payments when policies are cashed-in early

Normally we will not have passed on the full investment returns earned over policies' lifetimes as regular bonus. We therefore use final bonuses to 'top up' payouts so policyholders will also benefit from the rest of the investment returns.

Final bonus rates depend on when the investment was made. This helps ensure that performance is shared fairly between policies starting at different times, as these policies will have experienced different investment returns over their lifetimes.

We normally review final bonus at the middle and end of each year. At each of these reviews in 2016 the level of payouts were, in general, increased. This reflected the combination of stock market movements, the distribution from the Additional Account (please see section 2.5) and the operation of smoothing (see below). The combined effect of the bonus reviews in the year was to increase final payouts for the majority of policyholders who received payouts as a result of the declarations made in 2016.

SMOOTHING

The stockmarket goes up and down daily and can move a lot in a short space of time. With-profits investing includes a special feature called 'smoothing'. Smoothing works by keeping back some of the gains earned in good investment years to use them to help pay bonuses in poor investment years.

To achieve this smoothing effect we look at investment returns in the last two years. When these have been better than expected we keep back some of the returns when deciding on the final bonuses (which we normally do twice a year). When they have been poorer than expected we add to the returns when deciding the final bonuses. As explained in 'Your guide to with-profits', smoothing can increase or decrease maturity payouts for most policy types by up to 15%.

In 2016 our smoothing feature led to payouts being around 3% higher than they may have been if smoothing had not been applied during the first half of the year, but had little effect on payouts in the second half of the year.

PAYMENTS WHEN POLICIES ARE CASHED-IN EARLY

We follow a similar approach when setting payout values for policies that are cashed-in before their normal maturity or retirement dates, though usually with less smoothing being applied. Sometimes we may need to use Market Value Reductions to achieve this. Market Value Reductions reduce payouts when they would otherwise be too high when compared to the value of the underlying Scottish Widows With Profits Fund assets, for example following market falls.

We use Market Value Reductions only where necessary to protect customers still invested in the fund, by ensuring that those choosing to surrender were not paid more than their fair share (after allowing for some smoothing). Market Value Reductions applied for a small number of policies during 2016 but we were able to reduce them during the year. By the final quarter of the year no Market Value Reductions applied for our UK products.

TARGET RANGES FOR PAYOUTS IN 2016

'Asset shares' are, broadly, the accumulation of the amounts invested into policies. The asset shares of sample policies help us decide on the levels of final bonus and the payouts made when policies are surrendered. As stated in 'Your guide to with-profits', we aim that payouts fall within the following ranges around asset shares for these specimen policies (ignoring distributions from the Retained Account and Additional Account – please see section 2.5 below). These ranges describe the maximum expected possible extent of variation between a payout and the asset share. In practice the vast majority of payouts are clustered around 100% of asset share.

	Lower	Upper
Conventional With-Profits Policies	70%	145%
Unitised With-Profits Policies	80%	125%
Flexible Options Bond Income Fund	97%	103%
Flexible Options Bond Growth Fund	75%	125%

These target ranges do not apply to Unitised With-Profits Annuities and Pensionplanner contracts, and where payouts are increased by an adjustment for life insurance benefits.

The target ranges that applied in 2016, shown in the table above, allowed for the fullest extent of the smoothing of investment returns that could arise in volatile market conditions, in addition to the effect of grouping similar policies together when we set bonus rates (for example single rates of final bonus often apply for all policies of a particular type that were taken out in the same year, which is a further form of smoothing). On that basis, and bearing in mind that the target range describes the maximum possible difference between payouts and asset shares rather than a typical difference, we consider the ranges to be appropriate.

From time to time, including in 2016, we analyse the extent to which payouts may be distributed around asset shares for reasons other than the smoothing of investment returns (i.e. due to the grouping of policies). We separately monitor, at least weekly, the extent to which changes in investment markets are causing asset shares to move relative to our current payouts. By combining the results of those investigations and monitoring we are able to identify if payouts might be moving outside of the target ranges. During 2016 all payouts were within the ranges with the exception of a very small number of maturity payments on conventional with-profits life and pensions policies that were taken out in the late 1960s and 1970s. These policies have been provided with payouts that are consistent with maturity value projections that have been issued over the years and the financial impact on the With Profits Fund was negligible.

CHANGES TO THE TARGET RANGES

Following recent guidance published by the Financial Conduct Authority, which indicates that target ranges should be set in the context of moderate investment conditions, we will be changing our ranges to 80% to 120% (except for the Flexible Options Bond Income Fund). In moderate investment conditions we would already expect the majority of payouts to fall within that range but, where payouts might otherwise fall outside the range, we will be making some modest changes related to the grouping of policies described above. We will increase the final bonus rates that we set if we would otherwise expect any payouts to be less than 80% of asset share due to the grouping of policies, particularly for single premium policies that started at times when investment markets were volatile. This will not have a material cost for the with-profits fund as a whole, and there will be no impact from these changes for the vast majority of policies.

For the Flexible Options Bond Income Fund the target range will remain unchanged at 97% to 103% of asset share. We do not aim to smooth investment returns for the Flexible Options Bond Income Fund, and the target range therefore reflects only the modest variation that might arise before we would make a change to the rates of final bonus.

2.5. Payments from the Additional and Retained Accounts

The Additional Account is used to enhance final bonuses for with-profits policies purchased before Scottish Widows de-mutualised in 2000. An enhancement that increased payouts by up to around 6.5% was included in the final bonuses that were paid in 2016. The level of enhancement was reviewed in December 2016 and as a result we expect it to increase payouts by up to around 7% during the first half of 2017. It will be reviewed again in June 2017. Looking ahead, we expect the enhancement to increase over time, unless there is a market downturn or the with-profits fund suffers some other significant losses. In these events the distribution could be reduced or stopped.

The Retained Account consists of unclaimed demutualisation compensation, which is to be distributed over time as additional final bonus for with-profits policies purchased before Scottish Widows de-mutualised. An enhancement that increased payouts by up to around 2% was included in the final bonuses that were paid in 2016. We anticipate this will continue in 2017.

So overall these two Accounts increased payouts by up to 8.5% in 2016 and are expected to increase payouts by a similar amount in 2017.

2.6. With-profits policies issued to new customers

For some time, the number of new with-profits policies has been very low. This reflects a general reduction in demand for with-profits policies in the insurance market.

This has no significant effect on the prospects for your policy. This is because many aspects of the management of the fund are carried out as if the fund had closed to new policies when Scottish Widows de-mutualised in 2000. This includes the sharing out, as extra final bonus, of the Additional and Retained Accounts (which were set up at demutualisation). It also covers our strategic investment policy, for policies bought both before and after 2000 (which are expected to share a common mix of investments). Section 2.2 explains investment policy and section 2.5 explains the Additional and Retained Accounts.

The costs charged to the with-profits fund for administration are set by the court-approved Scheme that transferred the business of Scottish Widows plc into the company that is now named Scottish Widows Limited at the end of 2015. These cost charges vary with the number of policies in the fund, so fixed overheads do not become an increasing burden on the fund as it reduces in size.

2.7. Significant transactions in 2016

The Scottish Widows With Profits Fund contains policies under which the pension pot accumulated to the time of retirement can be converted on guaranteed terms into a pension. The pension, once in payment, is no longer a with-profits policy but the fund remains liable to pay the pension.

Over the years life expectancy has increased, and long term interest rates have fallen. This has made these guarantees very valuable, and most policyholders who have guarantees choose to exercise them. As a result the fund was liable to pay pensions to a large number of policyholders. As these pensions are themselves non-profit policies any losses arising from them, for example if pensioners live longer than expected, would be charged to the Additional Account (and any profits would be allocated to that Account). As future mortality rates are uncertain this makes the progression of the Additional Account uncertain, requiring an element of prudence in the way that it is paid out as extra bonus to with-profits policyholders. With the fund projected to get smaller as policies mature this would have become problematic for the stable operation of the Scottish Widows With Profits Fund.

To remove this uncertainty for the With Profits Fund in April 2016 the fund made a single 'buy-out' payment to our shareholder in relation to new annuities which had arisen from retirements in 2015 (a larger buy-out payment had been made in June 2015 in relation to annuities that had arisen before 2015). In return for the buy-out payment the shareholder took on the obligation to pay these pensions in future, and the associated risks. To ensure that the price paid by the fund was fair an independent expert provided advice to the With-Profits Committee.

The transfer of these pensions from the Scottish Widows With Profits Fund is expected to be of significant benefit to our with-profits policyholders.

We also put measures in place so that new pensions that have arisen since January 2016, and will arise in future, will be transferred immediately out of the Scottish Widows With Profits Fund. The price paid by the fund on each occasion reflects only our best estimate of the cost of providing the pension and a charge for the cost of risk capital that must be held. This arrangement was also finalised only after receiving advice from an independent expert.

2.8. The role of the With-Profits Committee

We have an independent With-Profits Committee. It reviews how the Scottish Widows With Profits Fund is managed and scrutinises any major proposal that affects the fund. It provides advice directly to the Board. An important responsibility of the Committee is to assess whether the interests of different groups of with-profits policyholders, other policyholders and shareholders have been properly addressed, and whether customers have been treated fairly. The Committee is provided with a variety of reports and information to enable it to carry out these assessments.

The Committee has four members, none of whom have any management or executive role with the company (or our parent company, Lloyds Banking Group). One member is a non-executive director of the company. The terms of reference set out the responsibilities of the Committee, and can be found at: **http://reference.scottishwidows.co.uk/docs/E2088.pdf**

2.9. How we ensure customers are treated fairly and in line with our Principles and Practices

There are five main controls in place to ensure this:

- The scrutiny provided by our With-Profits Committee, which is described above in section 2.8.
- Whenever we make important choices that affect the way we manage our with-profits policies, 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.
- Throughout the year, all the data, work and actions that supported our decisions have been recorded. The With-Profits Actuary has reviewed this evidence, and is satisfied the decisions were consistent with the PPFM, the Financial Conduct Authority (FCA) rules on Treating With-Profits Customers Fairly and the court-approved Scheme which covers the operation of the Scottish Widows With Profits Fund. He has stated that in his opinion the interests of policyholders have been taken into account in a fair and balanced way.
- The With-Profits Actuary has reported on this evidence to our With-Profits Committee covering the areas where decisions were made, and how they complied with the PPFM and with the rules of the FCA relating to the fair-treatment of with-profits customers.

- The With-Profits Committee also receives reports from our internal audit function, who review various aspects of our business and controls. Input from an independent actuary is also sought when appropriate. In 2016 independent actuarial advice was taken in relation to the transactions described in 2.7 above.

FURTHER INFORMATION ON OUR WITH-PROFITS FUND

We've produced a number of documents on our with-profits fund which you may find useful. These are:

- The PPFM
- Your Guide to With-Profits (a document also referred to as a Customer Friendly PPFM)
- A with-profits fund investment factsheet.

We provide copies of these documents on our website at:
http://scottishwidows.co.uk/ppfm

Statement from the With-Profits Actuary

In my opinion the discretion exercised by Scottish Widows Limited during 2016, and the report from the directors to which this statement is attached, have taken the interests of Scottish Widows' with-profits policyholders into account in a fair and balanced way. I base this opinion on the information and explanations provided to me by the company, including information requested by me, and the relevant rules and guidance issued by the Financial Conduct Authority.

Taking account of the information being provided in the report from the directors, this statement complies with the technical standards on data, insurance, modelling and reporting issued by the Financial Reporting Council.

Kevin Doerr
Fellow of the Institute and Faculty of Actuaries With-Profits Actuary
23rd March 2017

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