REPORT TO SCOTTISH WIDOWS WITH-PROFITS POLICYHOLDERS

REPORT ON PRINCIPLES AND PRACTICES
OF FINANCIAL MANAGEMENT (PPFM) FOR 2017

SCOTTISH WIDOWS

THIS ANNUAL REPORT TELLS YOU HOW WE HAVE MANAGED THE SCOTTISH WIDOWS WITH-PROFITS FUND IN 2017. 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 22nd March 2018 to consider the matters covered in this report including the statement provided by the With-Profits Actuary appended at the end of the report, and advice from the independent With-Profits Committee that it has reviewed the report and considers it appropriate for the Board to publish it. The Directors are satisfied that the Scottish Widows With-Profits Fund has been managed in accordance with the PPFM in all material respects with all errors identified being corrected.

The Directors of Scottish Widows Limited
22nd March 2018

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.
- By distributing the Additional Account, which was set up at demutualisation, to enhance the payouts of eligible policyholders in a prudent manner.

2. THE SCOTTISH WIDOWS WITH-PROFITS FUND IN 2017

2.1. Investment returns over 2017

Over 2017 most investment markets produced strong returns for sterling-based investors. Company shares (equities) performed well across all major geographic regions. In the UK, the FTSE All-Share Index rose by 13% over 2017. In developed overseas markets, the Asia Pacific (excluding Japan) region returned over 21%, whilst Europe (excluding the UK) returned over 17%, Japan returned over 14% and North America delivered a return of over 11% to sterling investors. Emerging markets also performed strongly, with the FTSE Emerging Markets Index returning over 21% in sterling terms.

In currency markets, Sterling appreciated (strengthened) against most major currencies over 2017, notably strengthening by around 10% relative to the US dollar. Sterling did however depreciate (weaken) relative to the euro by around 4% over 2017.

Fixed interest bonds issued by the UK Government and by UK companies delivered moderate returns, including the income generated. Global corporate bonds made marginal losses over 2017 due to the appreciation of sterling against most major currencies.

UK commercial property investments had a strong year, and returned over 11% as measured by the IPD UK Monthly Property Index

Given the strong performance from equity markets, absolute return funds (which aim to deliver positive returns in most market conditions) underperformed equities over the year.

Against this background, of strong performance from equities and the increase in the value of sterling against the dollar, the Scottish Widows With-Profits Fund produced an overall investment return on assets backing policies of 9% in 2017.

2.2. Investment policy

We choose the mix of assets with the aim of:

- getting the best possible long-term performance; subject to
- 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 2017 we:

- Made modest changes to the geographical split of equities based on medium term investment views.
- Purchased derivatives to protect the fund to downside risk from equity exposure.
- 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.
- Increased exposure to absolute return funds. This asset class aims to generate a positive return, even in poor market conditions, and is seen as a good source of diversification.

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 2017 included an increase in cash and UK equities and a decrease in allocation to both UK Government Bonds and Corporate bonds (fixed interest bonds issued by companies).
- 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 2017.

Asset Allocation	31 Dec 2015	31 Dec 2016	31 Dec 2017
Fixed interest			
• UK government bonds	5%	5%	3%
• Corporate bonds	12%	12%	10%
Loans secured against commercial property	3%	4%	4%
Property	14%	10%	11%
Equity shares			
• UK shares	20%	19%	22%
• Non-UK shares	23%	29%	29%
Absolute Return funds*	12%	12%	13%
Other investments (mainly cash deposits)	12%	9%	8%

* 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 section 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 regular bonus rates for conventional with-profits products were unchanged through 2017 but for the first half 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 2017 – 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 2017 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 2017.

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 and vice versa.

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 less 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 2017 our smoothing feature led to payouts being up to 5% lower than they may have been if smoothing had not been applied during 2017.

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). Throughout 2017 no Market Value Reductions applied for our UK products. In the first half of the year a small number of Market Value Reductions applied on Dollar denominated International Investment Bonds, however by the second half of the year these were removed entirely.

TARGET RANGES FOR PAYOUTS IN 2017

'Asset shares' are the amount resulting from the premiums invested, less deductions such as policy charges. They represent a fair share of the Fund for the policies to which they relate. The asset shares of specimen 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 a specified range around asset shares for these specimen policies (ignoring distributions from the Retained Account and Additional Account – please see section 2.5 below). In April 2017, as described in the 2016 Annual Report to Policyholders, the target range for both conventional and unitised with-profits polices was narrowed to 80% to 120% of asset share, following guidance from the Financial Conduct Authority. These ranges describe the maximum expected variation between the payout and asset share of a specimen policy. In practice the majority of payouts are clustered around 100% of asset share.

	Up to April 2017		From April 2017	
			Lower	Upper
Conventional With-Profits Policies	70%	145%	80%	120%
Unitised With-Profits Policies	80%	125%	80%	120%
Flexible Options Bond Income Fund	97%	103%	97%	103%
Flexible Options Bond Growth Fund	75%	125%	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.

For the Flexible Options Bond Income Fund the target range remains 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.

Based on representative specimen model points we regularly analyse the extent to which payouts may be distributed around asset shares for reasons other than the smoothing of investment returns (e.g. 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 2017 all payouts on specimen unitised with-profits policies were within the target range. However in the first quarter of the year, surrenders payouts on specimen conventional with-profits policies moved outside target range marginally; this prompted an out of cycle review of surrender payouts to be carried out in April 2017. Further there was a very small number of maturity payments on conventional with-profits life and pensions specimen policies that commenced in the late 1960s and 1970s which were outside target range. These policies have been provided with payouts that are consistent with maturity value projections that have been issued over the years.

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 7% was included in the final bonuses that were paid in 2017. The level of enhancement was reviewed in December 2017 and as a result we expect it to increase payouts by up to around 9% during the first half of 2018. It will be reviewed again in June 2018. 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 around 2% of asset shares at the point of demutualisation in 2000, was included in the final bonuses that were paid in 2017. We anticipate this will continue in 2018.

So overall these two Accounts increased payouts by up to around 9% in 2017 and are expected to increase payouts by up to around 11% in the first half of 2018.

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. As a result we are no longer actively seeking new with-profits business. The number of policies is therefore reducing as they reach maturity, pension customers reach retirement and other withdrawals are made.

This has no significant effect on the prospects for your policy. With-profits policyholders can expect to continue to benefit from a diversified investment policy (policies bought both before and after 2000 are expected to share a common mix of investments) and from the smoothing of returns. Section 2.2 explains investment policy and section 2.4 covers smoothing.

The costs charged to the with-profits fund for administration are set by the court-approved Part VII Scheme and 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. 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.

Throughout 2017 the Committee comprised 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**

2.8. 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 2.7.
- 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 in all material respects. 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.

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 2017, 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.

Alasdair Smith
Fellow of the Institute and Faculty of Actuaries With-Profits Actuary
22nd March 2018

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