

# Report to Clerical Medical UK With-Profits Policyholders

Report on Principles and Practices of Financial Management (PPFM) for 2016



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This annual report tells you how we have managed the Clerical Medical 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 Clerical Medical With-Profits Fund, held within Scottish Widows Limited.

All the different types of Clerical Medical with-profits policies sold in the UK, Europe and other overseas markets are supported by the same Clerical Medical With Profits Fund.

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 the 'With-profits summary' which summarises how we manage with-profits policies. This document can sometimes also be referred to as the 'CF PPFM' (customer friendly PPFM). The current version is also available on our website

[www.clericalmedical.co.uk](http://www.clericalmedical.co.uk)

If you have any further questions please contact us on **0345 788 3333**.

The Board of Scottish Widows Limited met on 20 March 2017 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 Clerical Medical With Profits Fund has been managed in accordance with the PPFM in all material respects.

The Directors of Scottish Widows Limited  
23 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 pay out a fair share of investment performance to with-profits policyholders (or any guaranteed amount, if higher).
- By aiming to achieve growth over the long term by having a significant proportion of the assets in higher-risk assets such as company shares and property, whilst ensuring that we can meet the With Profits Fund's guarantees.
- By aiming to smooth through some of the peaks and troughs of stock market values; and
- By 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. This means that we set the rate lower than we otherwise might do, and that we may set regular bonus rates at zero.

## 2. The Clerical Medical 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 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 Clerical Medical With Profits Fund produced an overall investment return on assets backing policies of 8.5% in 2016. (These assets backing policies, called asset shares, are described below).

## 2.2 Investment policy

Rather than have one investment strategy for the whole of the Clerical Medical With Profits Fund, different parts of the Fund follow different strategies.

- Asset shares are the amount resulting from investing premiums, less deductions such as policy charges. They represent a fair share of the Fund for the policies to which they relate. A significant proportion of the assets which support the asset shares is usually invested in higher risk assets, such as company shares and property, which have the potential for higher returns and therefore growth. Different investment mixes apply for the asset shares of UK policies and different classes of offshore policies.
- The remainder of the Fund is known as the 'estate', which is held as a cushion to support payouts in adverse conditions such as a fall in stock market values. Since 2010 part of the estate has been distributed to set higher amounts of final bonus than would otherwise apply. The estate, including the part being used to improve final bonuses, follows a more cautious investment strategy such as holding cash deposits or government bonds.

The Board reviews the strategic investment mix regularly. For asset shares, 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 (also taking account of the assets in the estate).

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	31-Dec-14	31-Dec-15	31-Dec-16
Fixed interest			
• UK government bonds	6%	3%	6%
• Corporate bonds	13%	14%	12%
Loans secured against commercial property	0%	2%	3%
Property	13%	14%	12%
Equity shares			
• UK shares	18%	17%	18%
• Non-UK shares	24%	20%	24%
Absolute Return funds*	9%	12%	13%
Other investments (mainly cash deposits)	17%	18%	12%

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

For detailed up-to-date information on where the Fund is invested please refer to our 'With-profits investment factsheet'. This is available from your financial adviser or on our website [www.clericalmedical.co.uk](http://www.clericalmedical.co.uk)

## 2.3 Regular 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 we may set regular bonus rates at 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 fixed interest assets. 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 most cases regular bonus rates were reduced slightly in February 2016, following a relatively poor year for investment markets in 2015. Regular bonus rates remain low in absolute terms in line with the approach described above. 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 market value reductions

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 those investment returns.

For unitised policies, if you come to take money out of the Clerical Medical With Profits Fund when a guarantee doesn't apply, we may need to make a reduction called a market value reduction (MVR). An MVR would only apply if the value of your units meant your investment would be worth more than your fair share (the asset share as explained in section 2.2). The MVR would have the effect of reducing the amount paid out, so that it was more in line with your fair share.

Final bonus rates and MVR 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.

Our final bonus rates and MVR rates have been kept under review, and have been changed in line with our published policy. We normally carry out reviews every six months, and did so at 1 February 2016 and 1 August 2016. As a result of these reviews the level of payouts reduced slightly for the majority of policyholders over 2016, (by c. 1% in February and c. 0.5% in August). This reflected the combination of market movements, the application of smoothing, and a reduction in the level of distribution of excess estate (please see below). Our review at 1 February 2017 has reversed these small reductions.

### Distribution of excess estate

At least once a year we determine whether the estate is more than is needed to meet the aims of the prudent management of the Clerical Medical With Profits Fund. A distribution of excess estate was started from 1 February 2010 by adding an extra amount within the bonuses when policies pay out.

We currently review the level of the estate against what is needed every six months. There may be times when we can increase the extra amount included in any final bonus due, but there may be times when we have to reduce it or possibly not pay anything extra at all.

At the reviews in 2016 a decrease was made in both February and August, reflecting significant falls in yields on low risk investments such as Government Bonds which leads to a higher value being placed on the fund's liabilities and so leaves less surplus to distribute. Despite these reductions the remaining distribution is still adding around 4.5% to payouts for fully eligible policies. You can check the extent to which your policy is eligible by looking at page 10 in the "With-profits summary" document.

For eligible policies we are currently planning to add to the distribution at a rate of 0.5% of asset share each year, though this is not guaranteed.

### Smoothing

Investment markets go up and down daily and can move a lot in a short space of time. A with-profits investment has a special feature called 'smoothing'. The effect of smoothing is to keep back some of the gains earned in good investment years and use them to help pay bonuses in poor investment years.

To support our aim that the Clerical Medical With Profits Fund continues to be well equipped to react to a range of investment conditions, we aim to ensure that the impact of smoothing does not affect the estate. We make an adjustment that spreads the impact of smoothing over the asset shares of all the policies in the Fund. This adjustment is currently calculated every six months. The adjustments resulting from these reviews in 2016 had the result that asset shares were reduced by 0.2% on 1 August 2016.

### Guarantee Costs

We guarantee a minimum payment from your policy on specific events. This guarantee is described in your policy documents. We currently make a deduction each year from the assets underlying with-profits policies to cover the cost of meeting those guarantees. We regularly monitor the level of deductions to make sure that it is fair for each group of policyholders, and as a result currently deduct less for premiums that were paid after 1 January 2008 than for premiums paid before 1 January 2008.

We plan to deduct no more than 1% in any one year, but in very adverse market conditions we may have to deduct more than this to ensure that guarantees are met across the Clerical Medical With Profits Fund. The deduction applied in 2016 was 0.3% of asset share for premiums paid before 1 January 2008, and 0.1% for later premiums.

Some older policies, where a deduction has already been made, and certain policies sold between January 2003 and September 2004, are not subject to this deduction. This is in line with our published policy.

## Target Ranges

We aim to pay amounts that are within 20% of the asset share. We expect to achieve this aim most of the time and for at least 90% of policies. We consider this range to be appropriate because the smoothing of investment returns and the sharing of the profits and losses made by the fund across wider groups of policies, to pool risk, are important features of with-profits. At the same time, payouts on individual policies will not be too far from asset shares.

Regular monitoring is undertaken to ensure that payouts do not fall outside of this range – if payouts do move outside of this range for a sustained period bonus rates may be recalculated to bring payouts back within the range. Payouts remained within ranges throughout 2016.

From time to time we review how payouts are distributed within these target ranges, with previous reviews finding that the majority of policies are clustered close to the centre of the range. The next such review is due to be undertaken in 2017.

Previously we had identified that payouts on surrender of some traditional whole-of-life policies had been lower than intended. In 2016 we completed an exercise to correct these payments, including interest. Affected customers were notified individually.

## 2.5 Administration costs

For all unitised business sold since 1996 there are no deductions for administration costs on policies other than the policy charges and the costs relating to buying, selling and holding assets. The policy charges are made in line with the terms of your policy.

For traditional business there are no stated deductions for charges. Instead we deduct an amount to cover the expenses of running the traditional policies including administration expenses, when we are calculating bonuses. We review the level each year to reflect our actual expenses on this block of business, and periodically check that the deductions are not out of line with comparable rates charged by other companies. One of these periodic checks was carried out in 2016 and confirmed that our charges are in line with other companies. The charges have been agreed by the Board on the advice of the With-Profits Actuary and are considered to be properly attributable to the Fund and to be fair and equitable.

## 2.6 With-profits policies issued to new customers

Over the last few years, the number of new customers investing in the Clerical Medical With Profits Fund has reduced. 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 does not change the prospects for our current with-profits customers or the protection offered by policies' guarantees and options. With-profits policyholders can also expect to continue to benefit from a diversified investment policy and from the smoothing of returns (section 2.4 explains smoothing).

## 2.7 The role of the With-Profits Committee

We have an independent With-Profits Committee. It reviews how the Clerical Medical 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.clericalmedical.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 that the decisions were consistent with the PPFM, the Financial Conduct Authority (FCA) rules on Treating With-Profits Customers Fairly and the court-approved Scheme that governs the operation of the Clerical Medical 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 Financial Conduct Authority 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 though in 2016 there were no instances where this was deemed necessary.

### Further information on with-profits:

We've produced a number of documents on our With-Profits Fund which you may find useful. These are:

- Principles and Practices of Financial Management ('PPFM')
- With-profits summary (a document which can sometimes also be referred to as a 'CF PPFM' or customer-friendly PPFM).
- With-profits investment factsheet.

You'll find copies of these documents and the latest information on bonus rates and MVRs on our website: [www.clericalmedical.co.uk](http://www.clericalmedical.co.uk)

#### 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 Clerical Medical 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  
23 March 2017

**[www.clericalmedical.co.uk](http://www.clericalmedical.co.uk)**

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