The Clerical Medical With Profits Fund

Principles and Practices of Financial Management (PPFM)

On 31 December 2015 Clerical Medical Investment Group Limited, which contains the Clerical Medical With-Profits Fund was renamed Scottish Widows Limited. This document describes the principles and practices that Scottish Widows Limited uses for the financial management of the Clerical Medical With-Profits Fund – the PPFM. The PPFM describes how we meet our responsibilities to with-profits policyholders and respond to changes in the business and economic environment.

The PPFM consists of principles and practices. The principles are enduring statements of the standards we adopt in managing the Clerical Medical With-Profits Fund. The practices work within the overall framework of the principles. They help a policyholder (we use the word 'you' in the rest of this document) understand the risks and benefits from holding a Clerical Medical with-profits policy.

Also available are customer-friendly versions of our PPFM which describe what a with-profits investment is and how we run it. This is called the 'With-profits summary', or in Europe the 'GGF guide'. It is aimed at policyholders and their advisers. The PPFM covers similar ground, but goes into greater detail, focusing on the standards, methods and controls we adopt to ensure we run with-profits robustly and fairly. It is aimed at advisers, but it is also available to policyholders. You can find more information on products that may be invested in with-profits in the relevant key features document. The PPFM has been produced to inform you – it has not been produced to promote or encourage further investment.

The PPFM describes the principles and practices for the entire Clerical Medical With-Profits Fund, for policies sold both in the UK and in other countries. The customer-friendly versions summarise the information relevant to the policies sold in the particular market.

This document is current as at August 2017. We will make changes to it from time to time. It reflects our current understanding of the law and regulations, which may change. In normal circumstances, we do not expect the principles to change, but we may change them in exceptional circumstances, for example to respond to fundamental changes in the business and economic environment. The practices can change as the company's and the Fund's circumstances and environment change. If we need to make a significant change to our approach, we will tell you about it. Normally, we will give at least three months' notice before we change a principle.

New business in the Fund is currently limited to:

- additional investment where existing policies allow it, including investment for new members of group schemes
- where pension policies issued in Germany and Austria allow a with-profits annuity to commence on retirement.

CONTENTS

The first two sections describe PPFM for the main UK bonus classes (post-1996 unitised UK with-profits policies) and for Guaranteed Growth Funds (GGFs). The last section describes variations for other types of policies.

INTRODUCTION

A with-profits investment is designed to be held for the medium and long term, which is more than five years. By investing in with-profits, you can benefit from the following:

- investment in a mix of assets, including company shares
- smoothing of the investment performance to reduce volatility
- an element of guaranteed performance. Guarantees are referred to generically in this document, in order to explain principles and practices. Information regarding specific guarantees can be found in policy literature.

The company runs two With-Profits Funds, the Clerical Medical With-Profits Fund and the Scottish Widows With-Profits Fund. This PPFM only relates to the Clerical Medical With-Profits Fund, with the Scottish Widows With-Profits Fund being covered by its own and separate PPFM. The Clerical Medical With-Profits Fund is a long-established fund that we run for current and future investors. All the different types of with-profits policies are supported by the same fund. The Fund's aim is to generate capital growth over the medium to long term (at least five years), with some stability over the short term. To do this, we follow the principles and practices described in the following sections. Key statements from the following sections are shown below.

Management of payouts on policies

We share out the distributable performance of our Clerical Medical With-Profits Fund (the 'profits') between its investors, through a system of bonuses. In this way, all of the investors share in the fortunes of the Fund. This does not mean that all investors get the same return. It depends, amongst other things, on the particular terms of their policies.

The main factor that determines the final payout is the distributable investment performance of assets held by the Clerical Medical With-Profits Fund. Other factors include a deduction that is currently made to help ensure that guarantees are met on policies across the whole Fund.

The words "Distributable performance of the Fund" are used throughout the PPFM to describe the performance of pools of assets within the Clerical Medical With-Profits Fund. It is used as the principal factor for determining payouts for the various bonus classes. This is explained further in the sections Fund separation, Types of policy in the Fund, Sub-division of the Fund on pages 32 to 33.

Investment management of the assets backing asset shares

Subject to helping to ensure the solvency of the company (Scottish Widows Limited) and its ability to meet the guarantees it provides on with-profits policies, we aim to achieve growth on the assets backing asset shares over the longer term and our policy for those assets is to have a significant proportion in higher-risk assets, such as company shares and property. Such assets may have higher growth potential, but their value tends to go up and down more.

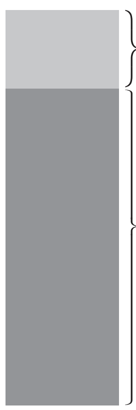
Management of the operation of the Fund

We run the Fund prudently to help the company meet the guarantees it provides on with-profits policies.

The Clerical Medical With-Profits Fund is kept separate from the funds supporting other policies.

We can choose how we operate the Fund, in line with the principles and practices described in this document. The Fund is run for the benefit of the policyholders, and where the operation of the Fund affects both policyholders and the company, we aim to ensure that both are treated fairly. We have a formal framework to ensure that this happens.

The Fund consists of two parts, as the diagram opposite shows. We aim to run with-profits in such a way that the estate continues to provide sufficient support and the company can meet the guarantees it provides. Following a review of the amount needed to support the Fund, a distribution of excess estate was started from 1 February 2010.



The estate: assets held to support payouts in adverse scenarios, for example to support temporary smoothing deficits, and for guarantee costs not charged to policies.

Asset shares: the amount resulting from investing premiums less deductions, used as the principal factor for determining each policy's share of the Fund.

MANAGEMENT OF THE PAYOUTS ON POLICIES (MAIN UK BONUS CLASSES)

We share out the distributable performance of our Clerical Medical With-Profits Fund (the 'profits') between its investors, through a system of bonuses. In this way, all of the investors share in the fortunes of the Fund. This does not mean that all investors get the same return. It depends, amongst other things, on the particular terms of their policies.

The main factor that determines the final payout is the distributable investment performance of the assets applicable to your policy. Other factors include:

- a deduction that may be made to help ensure that guarantees are met on policies across the whole Fund
- any addition from the distribution of excess estate.

The words "Distributable performance of the Fund" are used throughout the PPFM to describe the performance of pools of assets within the Clerical Medical With-Profits Fund. It is used as the principal factor for determining payouts for the various bonus classes. This is explained further in the sections Fund separation, Types of policy in the Fund, Sub-division of the Fund on pages 32 to 33.

This section relates to post-1996 unitised UK with-profits policies only. These are the main UK bonus classes sold since demutualisation, when Halifax (now part of the Lloyds Banking Group) took over Clerical Medical.

Principles

Factors affecting the final payout

The main factor that determines the final payout is the investment performance of the assets applicable to your policy.

Other factors are:

- how we share out the investment returns on the assets applicable to your policy through the smoothing process
- our charges, which are summarised in the illustration document
- taxes that we pay in the Fund
- any guaranteed minimum values which may apply
- a deduction that may be made to help ensure that guarantees are met on policies across the whole Fund. We may make a charge for the costs (including potential costs) of guarantees on with-profits policies (such as annuity guarantees). For example this may occur when investment returns are below guaranteed levels
- any addition from the distribution of excess estate.

The bonuses we pay aim to share out fairly the Fund's distributable performance between its investors. We aim to control the payout carefully to ensure that each investor does not get too much or too little.

Practices

Method used to determine the final payout: calculation of asset shares

In order to determine payouts, we calculate what is called the 'asset share'. Asset shares are the amount resulting from investing premiums, less deductions, and are used as the principal factor for determining each policy's share of the Fund.

In more detail, the asset share is calculated by applying to the investment any investment returns earned on the assets applicable to the policy over the period from the start of the investment. Included in this calculation will be any deductions for tax, charges and deductions to support the guarantees across the whole Fund and smoothing adjustments. These additions and deductions are explained in more detail under 'The parameters used in calculating asset shares' on page 3.

We then calculate a 'smoothed asset share' by looking at recent and future expected levels of investment markets. We calculate this on sample policies and aim to pay out close to this amount.

We calculate the smoothed asset share for the investment period by taking an average of the asset shares of policies of the same duration but with investment periods ending up to two years either side of the investment period for regular premium policies, and one year either side for single premium policies. This approach takes account of both recent market movements and movements at the time you took out your policy, and also expected future investment returns.

Methods

We calculate what has been earned on policies to help us decide final payouts. We may change the methods and parameters in these calculations to update or improve the calculation, including the historical part of the calculation. We may use estimates where exact information is not available, and we may change these estimates as more information becomes available.

Decision framework

The methods and parameters affecting final payouts are approved by the Board on the advice of the With-Profits Actuary. Any significant changes in approach are reviewed by the With-Profits Committee, which advises the company's Board. See pages 33 and 34 for more details.

In this way, the return you get is not based on the precise level of the investment markets on the day you invest, nor the precise level on the day you take money out. By smoothing through the ups and downs of market movements, you sometimes get higher returns than the unsmoothed performance and sometimes lower.

For some policies where regular premiums are payable all premiums are treated as repeated single premiums for the purpose of calculating smoothed asset shares and setting final bonus rates. This includes Employee Benefit Solutions products from July 2001, and all new group and grouped pensions schemes sold on or after 15 September 2003.

The process is adopted for sample policies to establish bonus rates which are then applied to actual policies. Where a guaranteed payout applies which is greater than the payout calculated by reference to current bonus rates, then the guaranteed amount is paid.

We use the same method for partial payouts as for whole payouts.

By following this process we aim to ensure that each investor gets a fair share of the Fund's distributable performance.

A distribution of excess estate was started from 1 February 2010. This is being done by additions to asset shares, to the extent that it is prudent. Any addition to asset shares results gradually in higher levels of final bonus added on payouts than would otherwise apply, or lower market value reductions (MVRs) where they apply. In the event that a guarantee applies when you take your money out, we pay the guaranteed amount if this is higher than the amount we would otherwise pay you when your policy is surrendered or matures.

The parameters used in calculating asset shares

Each parameter used in the asset share calculation is explained in more detail below.

Investment return: The Fund holds different groups of assets for different groups of policies. We use the investment returns of each group of assets to help determine the bonus for that group. We allow in the investment returns for the costs related to buying and selling assets.

Charges: For all unitised policies sold since 1996, when Clerical Medical (now named Scottish Widows Limited) became part of the Halifax Group (now part of the Lloyds Banking Group), the Fund operates a '100/0' structure. This means that there are no deductions for administration expenses on your policy other than the charges described in your policy literature, and the costs related to buying, selling and holding assets. Policy charges may only be increased in accordance with the terms of your policy. Deductions that may be made from the estate are described under Exceptional Costs – see page 33.

Tax: The Clerical Medical With-Profits fund incurs tax in a way that simulates a fund of a mutual insurance company. Each policy's asset share incurs tax at a rate consistent with such a basis.

Currently, no deductions for tax are made for pensions policies, except where taxes incurred overseas cannot be reclaimed.

Guarantee costs: We currently make a deduction from asset shares for the costs of guarantees on with-profits policies. We currently deduct these guarantee costs as they are incurred, deducting in each calendar year any costs arising in that year from money paid out on policies when guarantees apply. The deduction is spread across all with-profits policies except for bonus classes where deductions for guarantee costs have already been made (see the section 'Variations for different bonus classes' on page 35.)

The level of future deductions is uncertain as it depends on a number of factors including:

- Past and future performance of the assets applicable to policies invested in the Fund – for example, a deduction may be made if investment returns are below the guarantees on other policies.
- The overall level of money invested in and withdrawn from the Fund when guarantees apply.

We currently intend to deduct no more than 1% in any one year, but this is not a guarantee. In very adverse conditions we may have to deduct more than this to ensure that guarantees are met.

We regularly monitor the level of deductions to check that the deduction is fair for each group of policyholders as a whole. Since 1 February 2012 we have deducted less for premiums paid after 1 January 2008 than for premiums paid before 1 January 2008, but this may not continue in the future.

Smoothing adjustments: To help support our aim of ensuring that the Fund continues to be well equipped to react to a range of investment conditions, we ensure that smoothing surpluses (when payouts have been less than the corresponding asset shares) and deficits (when payouts have been greater than the corresponding asset shares) do not affect the estate. We make an adjustment that spreads the cumulative smoothing surplus or deficit over the asset shares of all the policies in the Fund. We do this every six months. When the smoothing account is in surplus (payouts have been less than the corresponding asset shares) we apply an increase to asset shares, and when the smoothing account is in deficit (payouts have been greater than the corresponding asset shares) we make a deduction.

Profits and losses from other parts of our business:
The Clerical Medical With-Profits Fund is kept separate from the funds supporting other policies (the Scottish Widows With-Profits Fund and the Combined Fund), although currently it holds a small amount – less than 0.5% by value – of other policies. We do not expect that the profits or losses arising from this business will have a significant effect on bonuses.

Amounts added from the estate

To distribute the estate while ensuring sufficient estate remains to safeguard the security of remaining policy benefits, we expect to gradually transfer amounts from the estate to increase asset shares.

We review periodically the level of estate against what is needed. There may be times when we can increase the amount being transferred to asset shares, but there may be times when we have to reduce it and we may need to transfer back some or all of what has been previously added to asset shares. The part of the estate which is added to asset shares is invested cautiously to help keep its value stable (see "Investment Management of the Estate" on page 31).

There are some policies that guarantee not to apply a market value reduction (MVR – see page 11) in certain circumstances, for example on selected retirement date. In these cases we will compare the payout including the extra amount, with the guaranteed amount and pay whichever is higher.

For money invested after 1 February 2010, the amount we add depends on when the money is invested; for an amount to be added there will need to be an increase in the level of estate distribution after the date the money is invested.

Eligibility for distribution of the excess estate

The following rules describe which with-profits policies are eligible to share in the distribution of the excess estate that started on 1 February 2010. Any changes in eligibility criteria for sharing in this or future distributions will be announced by the company at the time.

If you have a policy that commenced before 1 January 2011 and ended after 1 February 2010, you are eligible for any extra bonus amount relating to this estate distribution when you take money out of a with-profits policy.

If you had a policy that was ended before 1 February 2010, you won't be eligible for any such extra bonus amount.

Any policy taken out after 1 January 2011 will not be eligible for any such extra bonus amount.

Types of bonus

There are two types of bonus:

- a 'regular bonus'. We add this during the lifetime of your policy. This is done by increasing the value of the units you have in the Clerical Medical With-Profits Fund (the unit price) throughout the coming year.
- a 'final bonus' which is an additional bonus we might add when you take money out of the Clerical Medical With-Profits Fund.

Where a guarantee does not apply, we may need to make a reduction, called a market value reduction (MVR). Please refer to page 11 for more information on MVRs.

These rules are subject to exceptions and clarifications for certain policies, including the following:

- If you have an existing single premium policy that was in force as at 1 January 2011 and make an additional investment after that date, the additional investment won't be eligible for any such extra bonus amount.
- If you switch from another fund into with-profits after 1 January 2011, the investment won't be eligible for any such extra bonus amount.
- If you switched to another fund out of with-profits before 1 February 2010, you won't be eligible for any such extra bonus amount.
- If you have a regular premium policy that was in force as at 1 January 2011, the regular premiums and increments to regular premiums paid into the policy after 1 January 2011 will be eligible for any such extra bonus amount.
- If you have a pension policy that started before 1 February 2010, and your selected retirement date as stated in your policy certificate is after 1 January 2011, you'll be eligible for any such extra bonus amount when you get to your selected retirement date. But, if you decide to take benefits later than that, you'll only receive any such extra bonus amount added **on** your selected retirement date and you won't be eligible for any extra bonus amount on your policy **after** your selected retirement date.

Procedures

Any changes in methods or parameters are approved by the Board on the advice of the With-Profits Actuary. Any significant changes in approach are reviewed by the With-Profits Committee, which advises the Board (see pages 33 and 34).

The main methods, parameters and assumptions that we use are summarised in papers to the Board. The parameters and assumptions are derived from analysis of the relevant experience of the company and, where relevant, that of the industry generally. Changes to methods, parameters and assumptions are documented and material changes are subject to formal approval.

Types of bonus

We decide the regular bonus rate once a year, but we can change it mid-year if investment conditions change significantly.

We normally review final bonus rates twice a year, on 1 February and 1 August, but we may need to change them at other times of the year if investment conditions change significantly.

Final bonus rates and MVR rates vary depending on the start date of the policy. There are circumstances when both a final bonus and a market value reduction (MVR) can apply at the same time.

Regular bonus rates

Factors affecting regular bonus rates

- We take a long-term view of future economic conditions and the resulting investment returns. This is very important in deciding the regular bonus rate.
- We also 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, to help the company meet the guarantees it provides on with-profits policies.
- As markets fall, the potential cost of the guarantees increases, and we may have to make larger cuts in the regular bonus rate than we otherwise might do. In adverse investment conditions, the regular bonus rate could be very low or zero.
- The regular bonus rate also takes into account the tax we pay, and is quoted after the annual management charge has been taken.
- We change the regular bonus rate gradually each year. So the current regular bonus rate may be higher or lower than our long-term expectation.

We aim to set regular bonus rates which are broadly fair between policies of different type and term. For example, we may set different bonus rates depending on the guarantees and the assets associated with each bonus class.

We normally set the same regular bonus rate for both existing and new policies. However, we may set different rates if there is a significant change in investment conditions.

Final bonus rates

Aim

The aim of a final bonus is to top up the regular bonus already included in the final payout to reflect a fair share of the Fund's distributable performance.

A final bonus will only be added if the Fund's distributable performance allows it. The final bonus is not certain as it depends on the performance of the assets of the Fund applicable to your policy during the time your policy is invested with us.

Approach

When we decide the final bonus, we consider:

- the returns that the Fund has achieved on the assets of the Fund applicable to your policy over the term of your investment
- what the total payout should be, based on a fair share of the total Fund value after allowing for smoothing

Regular bonus rates

Method for setting the rates

We set a target regular bonus rate. We calculate this allowing for our long-term view of future economic conditions and the resulting investment returns. We set a target rate that is lower than the rate that could be supported based on our view of future investment returns. This allows a margin for final bonus. We aim to build up a sufficient margin from the start of a policy to allow for a possible 25% fall in the value of the Fund's assets. When the value of the Fund's assets is low, the potential cost of the guarantees increases, and we reduce the target regular bonus rate to allow for this.

We change the regular bonus rate gradually each year. So the current regular bonus rate may be higher or lower than our long-term expectation. We would not normally expect to change the rate by more than 1% at any one time. However, we may change the rate by more than this to protect the Fund, for example if stock markets are low and there is a significant increase in the potential cost of guarantees. For instance, in both 2003 and 2004, after three years of stock market falls, we reduced the rate by 1.5% in two stages, 1% from 1 February and 0.5% from 1 August.

When we set regular bonus rates we have to ensure the solvency of the Fund. In adverse circumstances, we may set regular bonus rates at zero, or make a bigger reduction in the regular bonus rate than we have made in the past.

The regular bonus rate also takes into account the tax we pay and for most bonus classes is quoted after the annual management charge has been taken.

Final bonus rates

Application

Final bonus rates vary by bonus class but within each bonus class, the same scale of final bonus rates applies for all types of payout from the Fund regardless of whether or not a guarantee applies when money is taken out of the Fund.

Allowance for part-years

The scales of final bonus rates apply rates that depend on the quarter-year of entry.

Policies with minimum regular bonus rate guarantees

We apply different final bonus rates to policies depending on the level of the minimum regular bonus guarantee that applies. In this way, the final bonus tops up the regular bonus already included in the final payout to reflect a fair share of the Fund's distributable performance.

- expected investment returns for the coming six months. Normally, we do not make changes to the final bonus during the coming six months, and only do so if there is a significant change in investment conditions from those we expected
- the amount paid out for similar policies in the immediate past.

Smoothing

Aims

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.

The return you get is not based on the precise level of investment markets on the day you invest, or the precise level on the day you take money out. By smoothing through the ups and downs of market movements, you may receive a higher or lower return than the unsmoothed performance.

We aim to:

- smooth through some of the peaks and troughs of investment markets
- return all the distributable investment performance earned to investors as a group
- pay out a fair share of distributable investment performance to each investor.

The investment performance of the assets in the Fund can vary considerably over time. Although we aim to smooth out some of the effects of these ups and downs, bonuses can still vary significantly over different investment periods.

In times of uncertainty when investment markets are volatile and there is an exceptionally large change in asset values, we may have to vary our approach to smoothing. Our aim is to ensure that we share out the distributable performance of the Fund fairly between all investors in the Fund and to be sure that the Fund can meet its guarantees.

Smoothing

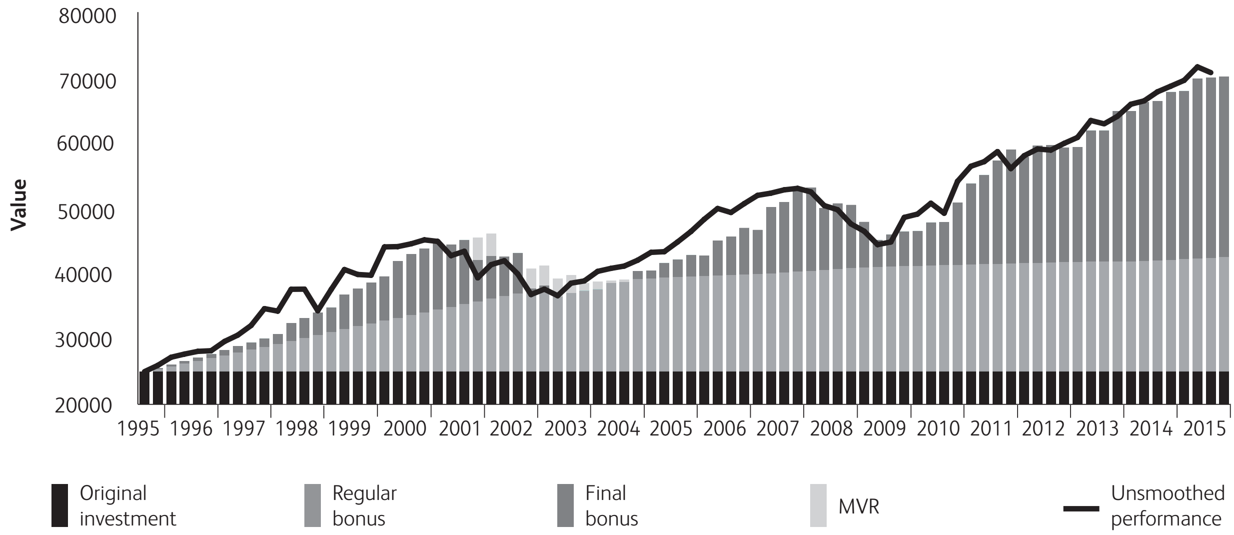
Degree of smoothing

The chart on the next page shows how we have operated smoothing on our With-Profits Bond since its launch in 1995. We have used the With-Profits Bond as an example, but the chart illustrates the principles for any of our with-profits products. Each column represents the amount payable if the money was taken out of the Fund on the date shown.

The chart compares the actual performance of the With-Profits Bond against the unsmoothed performance. The actual performance is based on regular bonuses added during the investment period and final bonuses added and MVR deducted when money is paid out. Please refer to page 11 for more information on MVRs.

This chart is for illustrative purposes only

An example of how smoothing works: With-Profits Bond investment returns since launch



Source: Scottish Widows Limited. Basis: £25,000 investment. The figure without market value reduction (MVR) would only be applicable where a guarantee was in force. The return is after deducting the annual management charge, but not the contract fees.

Period: 1 July 1995 to 1 October 2015.

Performance for the period 1 October 2010 to 1 October 2015, With-Profits Bond £33,206 (without MVR) £33,206 (with MVR). Unsmoothed performance for the period 1 October 2010 to 1 October 2015 £30,665.

The chart illustrates the effect of smoothing for one policy. The effect of smoothing varies between policies. The figures refer to the past and past performance is not a reliable indicator of future results. In particular, from 2009, we reduced the element of smoothing, so payouts will go up and down a bit more than they did before as they will reflect more closely market conditions at the time.

Target payout ratio

We aim to pay amounts that are within 20% of the asset share. For this purpose, we exclude from the asset shares any adjustments made from smoothing surpluses or deficits. The target payout ratio range is no more than a target: and so it is not guaranteed that the payout will be within the range. The bonus rates are not set with the objective of ensuring that any future payout is within the range, however it is expected that smoothing will lead to the target being met.

We expect to achieve that aim most of the time and for at least 90% of policies, but we may not achieve it all the time. For example, if stock markets rise or fall by unusual amounts in a short period, we may decide not to change bonuses immediately to adjust the amount being paid out, or we may limit the change to ensure it is not excessive.

One such occasion was early 2003, when stock markets had fallen sharply in the three years before, and the smoothing of payout changes meant that payouts without MVR were above 120% of asset share for a significant proportion of policies. Another occasion was 1999/2000, which saw a stock market high, and the smoothing of payout changes meant that payouts were generally below 100% of asset share – but mostly within 20% of asset share.

In practice, the ratio of payout to asset share changes over time.

Asset shares allow for the daily ups and downs of investment markets at the time the investment was made and at the time the money was taken out, but payouts smooth through the ups and downs. In this way, the ratio can be very different depending on when the money came into the Fund and when the money went out; this variability reflects the smoothing that is an inherent feature of with-profits.

The chart below shows how our payouts have been within our target of 20% of asset share for most of the time for the same policy as in the previous chart. The effect of smoothing varies between policies, and this is only one example.

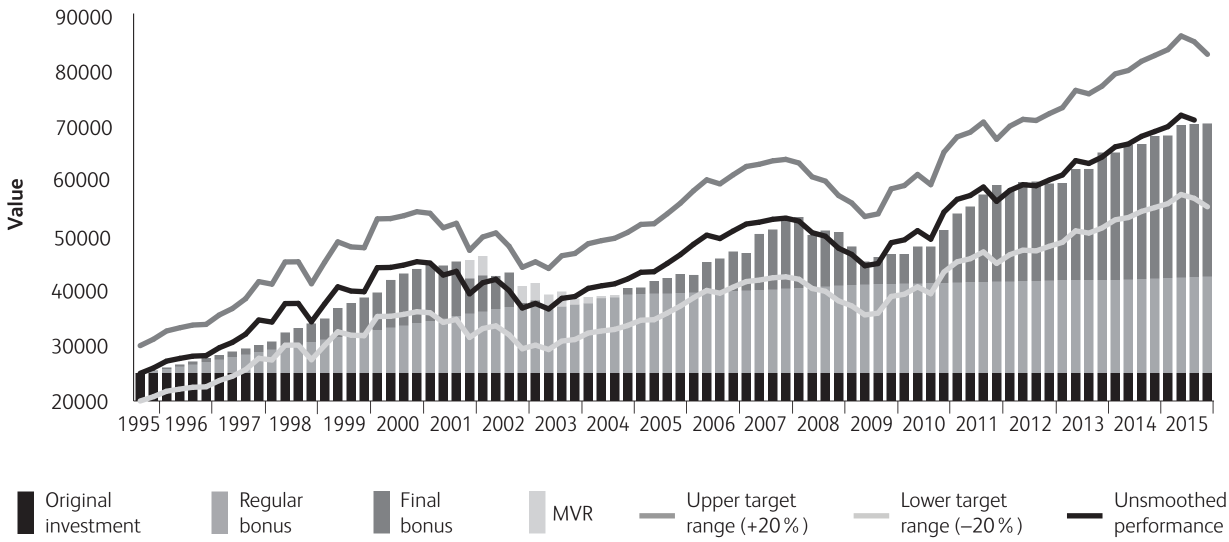
In the event that a guarantee applies when you take your money out, we pay the guaranteed amount even if this is higher than the asset share.

For policies that started in the first half of 2003, when stock markets hit a low point, we limit the smoothing adjustment to help meet the target payout ratio.

Maximum changes in payout
When we review final bonus rates, we may however override the target payout ratio rule to avoid an excessive change in the amount being paid out.

This chart is for illustrative purposes only

Working out your fair share – an example based on With-Profits Bond investment returns since launch



Source: Scottish Widows Limited. Basis: £25,000 investment. The figure without market value reduction (MVR) would only be applicable where a guarantee was in force. The return is after deducting the annual management charge, but not the contract fees.

Period: 1 July 1995 to 1 October 2015.

Performance for the period 1 October 2010 to 1 October 2015, With-Profits Bond £33,206 (without MVR) £33,206 (with MVR). Unsmoothed performance for the period 1 October 2010 to 1 October 2015 £30,665.

The chart illustrates the effect of smoothing for one policy. The effect of smoothing varies between policies. The figures refer to the past and past performance is not a reliable indicator of future results. In particular, from 2009 we reduced the element of smoothing, so payouts will go up and down a bit more than they did before as they will reflect market conditions at the time more closely.

Market value reductions (MVRs)

- In normal stock market conditions, we aim to apply the same smoothing approach on money taken out of the Clerical Medical With-Profits Fund, regardless of whether the money is being taken out in circumstances when guarantees apply. This is taken account of in the final bonus added to the amount we pay.
- Where a guarantee does not apply, we may need to make a deduction, called a market value reduction (MVR), which means we may pay out less than the value of the units.

  For example, we may do this when stock market values are low and a substantial amount of money is being taken out (or we anticipate it being taken out) of the Fund by investors. The deduction is made to protect the interests of remaining investors. If we didn't apply a deduction, the extra amount that we would pay would have to come from other investors who remain in the Fund.

At each review, we aim to limit how much we change the amounts being paid out. We currently apply limits as follows:

Maximum change on any policy*
over 6 months – 10%
over 12 months – 15%

**The change is calculated by comparing a policy for a particular start date, eg a policy started 1 April 1997 ending on a date six months ago with the same policy ending now. For regular premium policies, we make an allowance for the premiums paid during the period, the effect is to cap the change solely due to bonuses.*

In certain circumstances, we may increase these limits on changes:

- Sustained periods of depressed markets can mean that we are unable to limit reductions in payouts to these maximum changes and we have to increase the limits. If we were not to do this, we would pay too much to policyholders leaving the Fund, which would not be fair to investors remaining in the Fund. For example, we reduced payments by more than the maximum in the years 2000 to 2003, and 2007 to 2009, when there were large sustained falls in the stock market, with the FTSE-100 falling respectively 50% and 40% from its previous peak.
- If the excess estate available for distribution increases, we'll distribute it by increasing final bonus rates (and reducing MVR rates, where they apply) and we may increase the limits in order to distribute a fair share of that excess estate to investors leaving the Fund. Similarly, if the position of the Fund worsens and the amount available decreases, then we will reduce final bonus rates and increase MVR rates, and that reduction may be by more than our usual limits.

Market value reductions (MVRs)

When they might be applied
We may apply an MVR when the asset share on which rates are based is expected to be lower than the face value of the units, for example when stock markets are low. Prolonged periods of depressed markets can mean that we are not able to add a final bonus on some policies and we have to apply an MVR for a long period.

MVRs: review process and calculation methods
We regularly review MVRs as stock market values change, and if necessary change the level of MVR or remove it altogether. If we change MVRs for policies in one currency, we review them for the policies in other currencies too so that the MVRs remain consistent, allowing for the performance of the assets used for different groups of policies.

Our aim in doing this is to continue to pay out a fair share of investment performance to each investor, even in exceptional investment conditions. This is an example of how the different groups of with-profits investors collectively share in the distributable performance of the whole Clerical Medical With-Profits Fund. It demonstrates how we aim to achieve a consistent approach between different groups of investors, and between investors investing and taking out money from the Fund at different times.

- We apply MVRs to reduce payouts only for the effect of low asset values and for deductions for guarantee costs – for example because stock markets are low. We may apply an MVR that reflects changes in asset values with very little allowance for smoothing out the ups and downs of market movements over the term of the investment, ie close to the 'asset share'.

The method we use for setting MVR rates may vary and is based on both what is fair to policyholders taking money out of the Fund and what is necessary to protect the Fund for the benefit of remaining policyholders. For example, we may apply an MVR with reference to the level of the (unsmoothed) asset share, or we may apply a smaller reduction. As described earlier, the return you get is not based on the precise level of the investment markets on the day you invest, nor the precise level on the day you take money out. You sometimes get higher returns than the unsmoothed performance and sometimes lower. We aim to pay amounts that are within 20% of the asset share. We expect to achieve that aim most of the time and for at least 90% of policies, but we may not achieve it all the time.
We do not set a maximum limit on the percentage MVR that may be applied.

We apply different MVR rates to policies depending on the level of the minimum regular bonus guarantee that applies. In this way, the MVR adjusts what has already been added through regular bonuses to pay out a fair share of investment performance to each investor.

MANAGEMENT OF THE PAYOUTS ON POLICIES (GUARANTEED GROWTH FUNDS)

We share out the distributable performance of our Clerical Medical With-Profits Fund (the 'profits') between its investors, through a system of bonuses. In this way, all of the investors share in the fortunes of the Fund. This does not mean that all investors get the same return. It depends, amongst other things, on the particular terms of their policies.

The main factor that determines the final payout is the investment performance of the assets applicable to your policy. Other factors include:

- a deduction that may be made to help ensure that guarantees are met on policies across the whole Fund
- any addition from the distribution of excess estate.

The words "Distributable performance of the Fund" are used throughout the PPFM to describe the performance of pools of assets within the Clerical Medical With-Profits Fund. It is used as the principal factor for determining payouts for the various bonus classes. This is explained further in the sections Fund separation, Types of policy in the Fund, Sub-division of the Fund on pages 32 to 33.

Guaranteed Growth Funds (GGFs)

This section relates to Guaranteed Growth Funds (GGFs) only.

There are a number of GGFs. Each one may have different rates of Annual Dividend (the regular bonus), Claim Bonus Dividend (the final bonus when guarantees apply) and different surrender adjustments. The assets used to help set bonuses are different for each GGF.

The proportion in equities varies between GGFs. GGFs are available in a number of currencies, the main ones being Sterling, US dollar and Euro, and separate groups of assets are used for each currency. The assets for each currency have a similar mix of fixed-interest and higher-risk assets, but there are two differences between them:

- most of the assets are in the same currency as the GGF and are invested in the financial markets of that currency area
- the proportion of assets in property varies between each GGF currency.

Some GGF policies are reinsured into the company by CMI Insurance Company Limited ('CMI'). Under a reinsurance agreement CMI passes a part of each premium on each policy to the company to be invested in the Clerical Medical With-Profits Fund. When an investor takes money out of with-profits, the company passes the amount payable to CMI. In this way, policies invested in GGFs share in the profits earned in the Clerical Medical With-Profits Fund.

Principles

Factors affecting the final payout

The main factor that determines the final payout is the investment performance of the assets applicable to your policy.

Other factors are:

- how we share out the investment returns on the assets applicable to your policy through the smoothing process
- our charges for the product you have chosen
- taxes that we pay in the Fund
- any guaranteed minimum values which may apply
- a deduction that may be made to help ensure that guarantees are met on policies across the whole Fund. We may make a charge for the costs (including potential costs) of guarantees on with-profits policies (such as annuity guarantees). For example this may occur when investment returns are below guaranteed levels.

Practices

Method used to determine the final payout: calculation of asset shares

In order to determine payouts, we calculate what is called the 'asset share'. Asset shares are the amount resulting from investing premiums less deductions, and are used as the principal factor for determining each policy's share of the Fund.

In more detail, the asset share is calculated by applying to the investment any investment returns earned on the assets applicable to the policy over the period from the start of the investment. Included in this calculation will be any deductions for tax and charges, deductions to support the guarantees across the whole Fund and smoothing adjustments. These additions and deductions are explained in more detail under 'The parameters used in calculating asset shares' on page 3.

We then calculate a 'smoothed asset share' by looking at recent and future expected levels of investment markets. We calculate this on sample investments and aim to pay out close to this amount.

- any addition from the distribution of excess estate.

The bonuses we pay aim to share out fairly the Fund's distributable performance between its investors. We aim to control the payout carefully to ensure that each investor does not get too much or too little.

Methods
We calculate what has been earned on policies to help us decide final payouts. We may change the methods and parameters in these calculations to update or improve the calculation, including the historical part of the calculation. We may use estimates where exact information is not available, and we may change these estimates as more information becomes available.

Decision framework
The methods and parameters affecting final payouts are approved by the Board on the advice of the With-Profits Actuary. Any significant changes in approach are reviewed by the With-Profits Committee, which advises the Board. See page 33 and 34 for more details.

We calculate the smoothed asset share for the investment period by taking an average of the asset shares of policies of the same duration but with investment periods ending up to one year either side for single premium policies. This approach takes account of both recent market movements and movements at the time each premium was invested, and also expected future investment returns. In this way, the return you get is not based on the precise level of the investment markets on the day you invest, nor the precise level on the day you take money out. By smoothing through the ups and downs of market movements, you sometimes get higher returns than the unsmoothed performance and sometimes lower.

Where regular premiums are payable, all premiums are treated as repeated single premiums for the purpose of calculating smoothed asset shares and setting Claims Bonus Dividend rates.

This process is adopted for sample policies to establish bonus rates which are then applied to actual policies. Where a guaranteed payout applies which is greater than the payout calculated by reference to current bonus rates, then the guaranteed amount is paid.

We use the same method for partial payouts as for whole payouts.

By following this process we aim to ensure that each investor gets a fair share of the Fund's distributable performance.

A distribution of excess estate was started from 1 February 2010. This is being done by additions to asset shares, to the extent that it is prudent. Any addition to asset shares results gradually in higher levels of final bonus added on payouts than would otherwise apply, or lower market value adjusters (MVAs) where they apply. In the event that a guarantee applies when you take your money out, we pay the guaranteed amount if this is higher than the amount we would otherwise pay you when your policy is surrendered or matures.

For money invested after 1 February 2010, the amount we add depends on when the money is invested; for an amount to be added there will need to be an increase in the level of estate distribution after the date the money is invested.

Eligibility for distribution of the excess estate

The following rules describe which with-profits policies are eligible to share in the distribution of the excess estate that started from 1 February 2010. Any changes in eligibility criteria for sharing in this or future distributions will be announced by the company at the time.

If you have a policy that commenced before 1 January 2011 and ended after 1 February 2010, you are eligible for any extra bonus amount relating to this estate distribution.

If you had a policy that was ended before 1 February 2010, you won't be eligible for any such extra bonus amount.

These rules are subject to exceptions and clarifications for certain policies, including the following:

- If you have an existing single premium policy that was in force as at 1 January 2011 and make an additional investment, the additional investment will be eligible for any such extra bonus amount.
- If you have a regular premium policy that was in force as at 1 January 2011, the regular premiums and increments to regular premiums paid into the policy after 1 January 2011 will be eligible for any such extra bonus amount.
- If you have a policy that started before 1 January 2011 that allows you to reinvest for a further term at the end of the current investment term, as stated in your policy certificate, you'll be eligible for any extra bonus amount when you get to the end of the current investment term. And, if you decide to reinvest for a further term, you will be eligible for any such extra bonus amount on your policy after the reinvestment date.
- If you have a pension policy that started before 1 January 2011, you'll be eligible for any such extra bonus amount when you get to your selected retirement date, or take retirement on another date, or on your earlier death, as stated in your policy certificate. But you won't be eligible for any such extra bonus amount in any with-profits annuity payment after your retirement or to your spouse after your death.
- If you have a policy that was started before 1 January 2011 which offers a choice between sterling, dollar or euro with profits funds, you will be eligible for any such extra bonus amount if you switch from one currency to another. You will not however be eligible for any such extra bonus amount for the period after you've switched.

The parameters used in calculating asset shares

Each parameter used in the asset share calculation is explained in more detail below.

Investment return: The Fund holds different groups of assets for different groups of policies. We use the investment returns of each group of assets to help determine the bonus for that group.

We allow in the investment returns for the costs related to buying, selling and holding assets.

Charges: For GGFs, we operate a '100/0' structure. This means that there are no deductions for administration expenses on your policy other than the charges described in your policy literature, and the costs related to buying, selling and holding assets. These charges are fixed, except that the annual management charge and administration fee may be increased under the terms of some policies. Deductions that may be made from the estate are described under Exceptional Costs – see page 33.

Tax: The Clerical Medical With-Profits Fund incurs tax in a way that simulates a Fund of a mutual insurance company. Each policy's asset share incurs tax at a rate consistent with such a basis. Currently, no deductions for tax are made for GGFs, except where tax deducted from income from assets cannot be reclaimed.

Guarantee costs: We currently make a deduction from asset shares for the costs of guarantees on with-profits policies. We currently deduct these guarantee costs as they are incurred, deducting in each calendar year any costs arising in that year from money paid out on policies when guarantees apply. The deduction is spread across all with-profits policies, except for bonus classes where deductions for guarantee costs have already been made (see the section 'Variations for different bonus classes' on page 35).

The level of future deductions is uncertain as it depends on a number of factors including:

- Past and future performance of the assets applicable to policies invested in the Fund – for example, a deduction may be made if investment returns are below the guarantees on other policies.
- The overall level of money invested in and withdrawn from the Fund when guarantees apply.

We currently intend to deduct no more than 1% in any one year, but this is not a guarantee. In very adverse conditions we may have to deduct more than this to ensure that guarantees are met.

We regularly monitor the level of deductions to check that the deduction is fair for each group of policyholders as a whole. We are currently deducting less for premiums paid after 1 January 2008 than for premiums paid before 1 January 2008, but this may not continue in the future.

Smoothing adjustments: To help support our aim of ensuring that the Fund continues to be well equipped to react to a range of investment conditions, we ensure that smoothing surpluses (when payouts have been less than the corresponding asset shares) and deficits (when payouts have been greater than the corresponding asset shares) do not affect the estate. We make an adjustment that spreads the cumulative smoothing surplus or deficit over the asset shares of all the policies in the Fund. We do this every six months. When the smoothing account is in surplus (payouts have been less than the corresponding asset shares) we apply an increase to asset shares, and when the smoothing account is in deficit (payouts have been greater than the corresponding asset shares) we make a deduction.

Profits and losses from other parts of our business:
The Clerical Medical With-Profits Fund is kept separate from the fund supporting other policies (the Scottish Widows With-Profits Fund and the Combined Fund), although currently it holds a small amount – less than 0.5% by value – of other policies. We do not expect that the profits or losses arising from this business will have a significant effect on bonuses.

Amounts added from the estate

To distribute the estate while ensuring sufficient estate remains to safeguard the security of remaining policy benefits, we expect to gradually transfer amounts from the estate to increase asset shares.

We review periodically the level of estate against what is needed. There may be times when we can increase the amount being transferred to asset shares, but there may be times when we have to reduce it and we may need to transfer back some or all of what has been previously added to asset shares. The part of the estate which is added to asset shares is invested cautiously to help keep its value stable (see “Investment Management of the Estate” on page 31).

When you take money out of the Fund in circumstances specified in your policy, for example at the end of the investment term, we guarantee to pay the accumulated value of units on your policy, including the Annual Dividends added to your investment. In such circumstances, we will compare the payout including the extra amount, with the guaranteed amount, and pay whichever is higher.

Procedures
Any changes in methods or parameters are approved by the Board on the advice of the With-Profits Actuary. Any significant changes in approach are reviewed by the With-Profits Committee, which advises the Board (see pages 33 and 34). The main methods, parameters and assumptions that we use are summarised in papers to the Board. The parameters and assumptions are derived from analysis of the experience of the company and, where relevant, that of the industry generally. Changes to methods, parameters and assumptions are documented and material changes are subject to formal approval.

Types of bonus

There are two types of bonus:

- An Annual Dividend. We add this during the lifetime of your policy. This is done by increasing the value of the units you have in the GGF (the unit price) throughout the coming year.
- A Claim Bonus Dividend which is an additional bonus we might add when you take money out of the GGF when guarantees apply.

Where a guarantee does not apply, we apply a different smoothing approach through surrender adjustments. Please refer to page 22 for more information on surrender adjustments.

Types of bonus

We decide the Annual Dividend rate once a year on 1 February.

We normally review Claims Bonus Dividend rates twice a year, on 1 February and 1 August, but we may need to change at other times of the year if investment conditions change significantly.

Claims Bonus Dividend rates and surrender adjustments vary depending on the start date of the policy.

Annual Dividend rates

Factors affecting Annual Dividend rates

- We take a long-term view of future economic conditions and the resulting investment returns. This is very important in deciding the Annual Dividend rate.
- We also have to bear in mind that, where guarantees apply, we cannot take away Annual Dividends once we have added them to your investment. This means that we set the rate lower than we otherwise might do, to help the company meet the guarantees it provides on with-profits policies.
- As markets fall, the potential cost of the guarantees increases, and we may have to make larger cuts in the Annual Dividend rate than we otherwise might do. In adverse investment conditions, the Annual Dividend rate could be very low or zero.
- The Annual Dividend rate also takes into account the tax we pay, and is quoted after the annual management charge has been taken.
- We change the Annual Dividend rate gradually each year. So the current Annual Dividend rate may be higher or lower than our long-term expectation.

We aim to set Annual Dividend rates which are broadly fair between policies of different type and term. For example, we may set different bonus rates depending on the guarantees and the assets associated with each bonus class.

We normally set the same Annual Dividend rate for both existing and new policies. However, we may set different rates if there is a significant change in investment conditions.

Annual Dividend rates

Method for setting the rates

We set a target Annual Dividend rate. We calculate this allowing for our long-term view of future economic conditions and the resulting investment returns. We set a target rate that is lower than the rate that could be supported based on our view of future investment returns. This allows a margin for Claims Bonus Dividend. We aim to build up a sufficient margin from the start of a policy to allow for a possible 25% fall in the value of the Fund's assets. When the value of the Fund assets is low, the potential cost of the guarantees increases, and we reduce the target rate to allow for this.

We change the Annual Dividend rate gradually each year. So the current Annual Dividend rate may be higher or lower than our long-term expectation. We would not normally expect to change the rate by more than 1% at any one time. However, we may change the rate by more than this to protect the Fund, for example if stock markets are low and there is a significant increase in the potential cost of guarantees. For instance, in both 2003 and 2004, after three years of stock market falls, we reduced the rate by 1.5%.

When we set Annual Dividend rates, we have to ensure the solvency of the Fund. In adverse circumstances, we may set Annual Dividend rates at zero, or make a bigger reduction in the Annual Dividend rate than we have made in the past.

The Annual Dividend rate is quoted after the annual management charge has been taken.

Claims Bonus Dividend rates

Aim

The aim of a Claims Bonus Dividend is to top up the Annual Dividend already included in the final payout to reflect a fair share of the Fund's distributable performance.

A Claims Bonus Dividend will only be added if the Fund's distributable performance allows it. The Claims Bonus Dividend is not certain as it depends on the distributable performance of the assets of the Fund applicable to your policy during the time your policy is invested with us.

Approach

When we decide the Claims Bonus Dividend, we consider:

- the returns achieved on the assets of the Fund applicable to your policy over the term of your investment
- what the total payout should be, based on a fair share of the total distributable Fund value after allowing for smoothing

Claims Bonus Dividend rates

Allowance for part-years

The scales of Claims Bonus Dividend rates apply the same rate for all investments in the same quarter-year.

- expected investment returns for the coming six months. Normally, we do not make changes to the Claims Bonus Dividend during the coming six months, and only do so if there is a significant change in investment conditions from those we expected
- the amount paid out for similar policies in the immediate past

Smoothing

Aims

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.

The return you get is not based on the precise level of the investment market on the day you invest, nor the precise level on the day you take money out. By smoothing through the ups and downs of market movements, you may receive a higher or lower return than the unsmoothed performance.

We aim to:

- smooth through some of the peaks and troughs of investment markets
- return all the distributable investment performance earned to investors as a group
- pay out a fair share of distributable investment performance to each investor.

The investment performance of the assets in the Fund can vary considerably over time. Although we aim to smooth out some of the effects of these ups and downs, bonuses can still vary significantly over different investment periods.

In times of uncertainty when stock markets are volatile and there is an exceptionally large change in asset values, we may have to vary our approach to smoothing. Our aim is to ensure that we share out the distributable performance of the Fund fairly between all investors in the Fund and to be sure that the Fund can meet its guarantees.

Smoothing

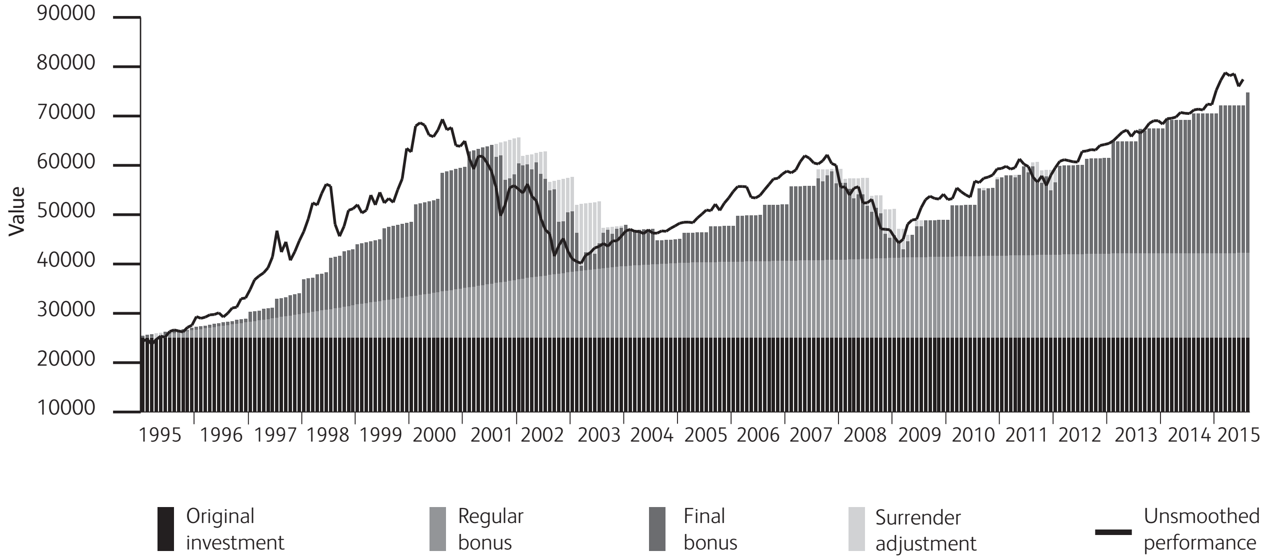
Degree of smoothing

The chart overleaf shows how we have operated smoothing on GGF1 since its launch in 1995. We have used GGF series 1 as an example, but the chart illustrates the principles for any of our with-profits products. Each column represents the amount payable if the money was taken out of the Fund on the date shown.

The chart compares the actual performance of GGF series 1 against the unsmoothed performance. The actual performance is based on Annual Dividends added during the investment period and Claims Bonus Dividends added and MVAs deducted when money is paid out. Please refer to page 22 for more information on MVAs.

This chart is for illustrative purposes only

An example of how smoothing works: Euro Guaranteed Growth Fund I investment returns since launch



Source: Scottish Widows Limited. Basis: €25,000 investment. The final bonus before any surrender adjustment would be applicable only where a guarantee is in force, for example on death or at the end of the investment term. Please refer to page 22 for more information on surrender adjustments. The return is after deducting the annual management charge, but not the contract fees. Period: 1 January 1995 to 1 August 2015.

The chart illustrates the effect of smoothing for one policy. The effect of smoothing varies between policies. In particular, from 2009 we reduced the element of smoothing, so payouts will go up and down a bit more than they did before as they will reflect market conditions at the time more closely. The figures refer to the past and past performance is not a reliable indicator of future results.

Target payout ratio

We aim to pay amounts that are within 20% of the asset share. For this purpose, we exclude from the asset shares any adjustments made from smoothing surpluses or deficits. The target payout ratio range is no more than a target: and so it is not guaranteed that the payout will be within the range. The bonus rates are not set with the objective of ensuring that any future payout is within the range, however it is expected that smoothing will lead to the target being met.

We expect to achieve that aim most of the time and for at least 90% of policies, but we may not achieve it all the time. For example, if stock markets rise or fall by unusual amounts in a short period, we may decide not to change bonuses immediately to adjust the amount being paid out, or we may limit the change to ensure it is not excessive.

One such occasion was early 2003, when stock markets had fallen sharply in the three years before, and the smoothing of payout changes meant that payouts where guarantees applied were above 120% of asset share for a significant proportion of policies. Another occasion was 1999/2000, which saw a stock market high, and the smoothing of payout changes meant that payouts were generally below 100% of asset share – but mostly within 20% of asset share.

In practice, the ratio of payout to asset share changes over time. Asset shares allow for the daily ups and downs in investment markets at the time the investment was made and at the time the money was taken out, but payouts smooth through the ups and downs. In this way, the ratio can be very different depending on when the money came into the Fund and when the money went out; this variability reflects the smoothing that is an inherent feature of with-profits.

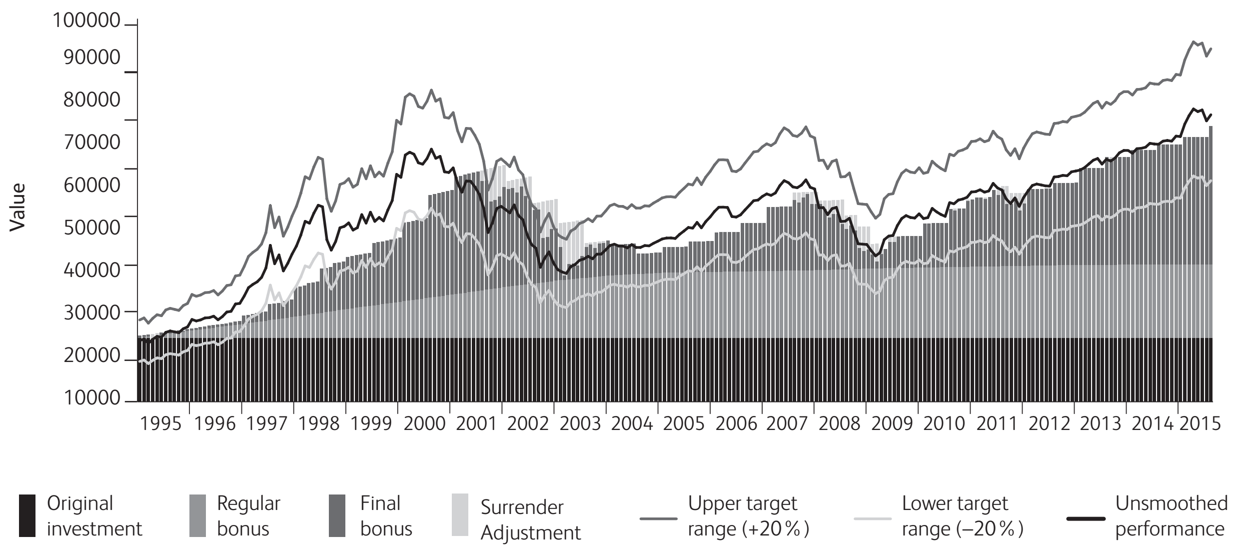
The chart below shows how our payouts have been within our target of 20% of asset share for most of the time for the same policy as in the previous chart. During the investment period of this example, financial markets experienced exceptional rises and falls, which meant that our smoothing rules did not at all times achieve our aim of paying amounts within 20% of asset share. The effect of smoothing varies between policies, and this is only one example.

In the event that a guarantee applies when you take your money out, we pay the guaranteed amount even if this is higher than the asset share.

For policies that started in the first half of 2003, when stock markets hit a low point, we limit the smoothing adjustment to help meet the target payout ratio.

This chart is for illustrative purposes only

Working out your fair share – an example based on Euro Guaranteed Growth Fund I investment returns since launch



Source: Scottish Widows Limited. Basis: €25,000 investment. The final bonus before any surrender adjustment would be applicable only where a guarantee is in force, for example on death or at the end of the investment term. Please refer to page 22 for more information on surrender adjustments. The return is after deducting the annual management charge, but not the contract fees. Period: 1 January 1995 to 1 August 2015.

The chart illustrates the effect of smoothing for one policy. The effect of smoothing varies between policies. In particular, from 2009 we reduced the element of smoothing, so payouts will go up and down a bit more than they did before as they will reflect market conditions at the time more closely. The figures refer to the past and past performance is not a reliable indicator of future results.

Maximum changes in payout

When we review Claims Bonus Dividend rates, we may however override the target payout ratio rule to avoid an excessive change in the amount being paid out.

At each review, we aim to limit how much we change the amounts being paid out. We currently apply limits as follows:

Maximum change on any policy*
over 6 months – 10%
over 12 months – 15%

**The change is calculated by comparing a policy for a particular start date, eg a policy started 1 April 1997 ending on a date six or twelve months ago with the same policy ending now.*

In certain circumstances, we may increase these limits on changes:

- Sustained periods of depressed markets can mean that we are unable to limit reductions in payouts to these maximum changes and we have to increase the limits. If we were not to do this, we would pay too much to policyholders leaving the Fund, which would not be fair to investors remaining in the Fund. For example, we applied higher maximum changes in the years 2000 to 2003 and 2007 to 2009, when there was a large sustained fall in the stock market, with the Eurostoxx 50 falling respectively over 66%/60% from its previous peak.
- If the excess estate available for distribution increases, we'll distribute it by increasing final bonus rates (and reducing MVA rates, where they apply) and we may increase the limits in order to distribute a fair share of that excess estate to investors leaving the Fund. Similarly, if the position of the Fund worsens and the amount available decreases, then we will reduce final bonus rates and increase MVA rates, and that reduction may be by more than our usual limits.

Smoothing – surrender adjustments (including MVAs)

We apply a different smoothing approach on money taken out when guarantees do not apply: we apply surrender adjustments.

If investment performance has been good enough over the time that you have been in the Fund, we pay a Surrender Bonus Dividend in addition to the Annual Dividends that have already been added. If the investment performance has not been good enough, we make a deduction called a Market Value Adjuster (MVA), and pay out less than the value of units.

The MVA deduction is made to protect the interests of remaining investors. If we didn't apply a deduction, the extra amount that we would pay would have to come from other investors who remain in the Fund.

Smoothing – surrender adjustments (including MVAs)

As described earlier, we aim to pay amounts that are within 20% of the asset share. We expect to achieve that aim most of the time and for at least 90% of policies, but we may not achieve it all the time.

We normally review the surrender adjustments once a month. The surrender adjustments reflect changes in asset values with limited allowance for smoothing over the term of the investment. This is effectively close to the 'asset share'. We do not set a maximum limit on the percentage MVA that may be applied.

Our aim in doing this is to continue to pay out a fair share of investment performance to each investor, even in exceptional investment conditions. This is an example of how the different groups of with-profits investors collectively share in the distributable performance of the whole Clerical Medical With-Profits Fund. It demonstrates how we aim to achieve a consistent approach between different groups of investors, and between investors investing and taking out money from the Fund at different times.

We apply MVAs to reduce payouts only for the effect of low asset values and for deductions for guarantee costs – for example because stock markets are low. We may apply an MVA that reflects changes in asset values with very little allowance for smoothing out the ups and downs of market movements over the term of the investment, ie close to the asset share.

INVESTMENT MANAGEMENT OF THE ASSETS BACKING ASSET SHARES

Subject to helping to ensure the solvency of the company and its ability to meet the guarantees it provides on with-profits policies, we aim to achieve growth on the assets backing asset shares over the longer term, and our policy for those assets is to have a significant proportion in higher-risk assets, such as company shares and property. Such assets may have higher growth potential, but their value tends to go up and down more.

The investment strategy differs between the assets backing asset shares and the other assets in the Clerical Medical With-Profits Fund – the estate. For the investment strategy of the estate, including the part of the estate which is being added to asset shares, please see page 31. This section describes the investment practices for the assets backing asset shares.

Principles

Investment strategy

Core Principles

- We invest primarily for the benefit of the policyholders, not for the benefit of the company.
- Subject to helping to ensure the solvency of the company and its ability to meet the guarantees it provides on with-profits policies, we aim to achieve growth on the assets backing asset shares over the medium and long term – periods of five years and more.
- The investment strategy for the assets backing asset shares depends on:
  – our view of investment markets at the time
  – the surplus of assets over liabilities in the Fund
  – the guarantees on the policies for which the assets are being invested.
- Within these principles, our policy is to have a significant proportion in higher-risk assets, such as company shares and property. Such assets are higher risk than fixed-interest investments, and their value tends to go up and down more. But over longer periods they have tended to produce better returns.
- Within asset classes we hold a wide range of individual assets. This enables us to diversify the investment risk.
- We monitor the Fund strength and market conditions regularly, and can vary the investment strategy as a result. From time to time we may make changes to the investment strategy as a result of the factors above, which could result in the proportion of higher risk assets changing significantly.

Practices

Investment practice

The assets backing asset shares include cash, fixed-interest and index-linked securities, equities (company shares) and property. We may also include other types of asset. There are holdings in different types of bonds, equities in different industries, countries and currencies, and property of different types and in different locations. We sometimes also use a type of asset called a derivative. An example of a derivative is an investment contract that gives a return that depends on the performance of shares, property or fixed-interest investments, without having to buy or sell the underlying assets themselves.

We group policies of similar types and manage pools of assets separately for these groups of policies.

Proportion in higher-risk assets

We monitor and manage where the Clerical Medical With-Profits Fund is invested. We will change the asset mix (where the Fund is invested) for the assets backing asset shares, applying the principles described in the left-hand column. Any changes we make will aim to ensure that the Fund continues to generate the best possible returns as well as being able to meet all of the guarantees. Higher risk assets tend to have higher growth potential, but their value can go down more as well as up.

We have put protection measures in place that help to safeguard the future growth potential of the assets backing asset shares reducing the likelihood that in the event of a significant stock market fall, we would have to significantly reduce the proportion in higher risk assets. This protection is achieved through the investment strategy of the estate (see page 31).

Even though the Fund has this protection in place and even though any available assets outside the Fund can be loaned to the Fund to prevent a deficit arising, the Fund will not be immune from stock market falls. If there are large falls, and it looks likely that the Fund cannot meet the guarantees on policies in the Fund, we may reduce the proportion in higher risk assets to zero. This is not the only reason for reducing the proportion in higher risk assets; we may do this for strategic reasons, for example based on our investment view at the time.

Specific Principles

- In setting the investment strategy for the assets backing asset shares, we consider the different types of policy in the Fund. For each type of policy we consider the currency of the investment and the policy conditions including guarantees, and the existing and likely future duration of the policies. We may group policies of similar types and manage pools of assets separately for these groups of policies. This ensures that the overall investment strategy is suitable for the specific policies within the Fund.
- We may use derivatives for tactical or strategic purposes. We will only use derivatives if it allows us to manage the portfolio more cost effectively, or more efficiently, or to meet regulatory requirements. For instance, derivatives may help the Fund to meet guarantees in adverse investment conditions, or to enable us to effect a change in asset allocation more quickly, or to limit the possible effect on payouts of adverse investment conditions.
- If we invest in assets that are not normally traded it will be because we believe that they will offer additional investment returns or reduce the risk of the Fund. The benefits of any such investment would accrue to the Fund and hence policyholders.

Decision framework

The Board sets the investment strategy. This strategy includes the asset allocation strategy and rules for the fund manager to follow. The Board periodically reviews the appropriateness of this strategy, as well as monitoring the investment performance and compliance with the rules and policies set.

The Board formulates policies to monitor, measure and manage risk. For example, we restrict holdings to any one counter-party to reduce the risk of loss if a single counter-party defaults.

Investment in business ventures etc

We do not use the Clerical Medical With-Profits Fund to support business ventures in other parts of our group of companies. Nevertheless, we may use the assets of the Clerical Medical With-Profits Fund to take advantage of investment opportunities, (including opportunities with connected companies), which may arise from time to time, where we expect such use to be of benefit to the Clerical Medical With-Profits Fund. Such use is subject to review by the With-Profits Committee, which advises the Board (see pages 33 and 34).

Decision framework

The Board sets the investment strategy. The Board discharges its responsibilities through the use of committees, including committees of the Insurance Business of Lloyds Banking Group, and executives within the company.

Relevant committees take into account the views of the With-Profits Actuary to help ensure that the investment policies satisfy the customer’s expectations and are fair.

Investment process

We adopt a two-tiered approach to investment for the assets backing asset shares.

- Allocation between asset classes – We consider the proportions invested in different types of asset such as company shares, fixed interest, cash and property.
- Individual asset selection – Our investment manager then invests in suitable assets within each asset class taking into account the investment risk.

The aim of the investment process is to maximize the potential return whilst setting a limit on the Fund’s overall investment risk. We may choose to manage holdings in some asset classes so that those assets track market indices. We may allow the fund manager greater freedom in selecting individual assets for other asset classes.

Allocation between asset classes

Each year, or more frequently where appropriate, the Board decides the strategic asset allocation, setting a benchmark and tolerances around how much of the Fund we wish to invest in each type of asset which allows for some short term, tactical asset allocation where our investment managers believe this will add value. The Board bases its decision on advice from:

- its actuaries, including the With-Profits Actuary, who takes into account the expectations of the customers, the nature and term of all the policies in the Fund, the riskiness of different types of asset, and the likely financial resources of the Fund, in different business and economic scenarios.
- its Investment Committees, which take into account economic factors, market prospects, volatility and valuations for each of the many financial markets.

Individual asset selection

Our investment managers have teams of fund managers responsible for selecting the investments for the Fund. For those asset classes where we choose to take an active approach to managing the mix of holdings, the fund managers use systematic processes aiming to identify the most attractive individual assets.

When considering asset selection we also consider the following factors

- we hold a certain proportion of the available funds in cash. This is used to ensure liquidity from both a business and investment point of view
- when investing in bonds we invest in Government Bonds and may also invest in corporate bonds, index-linked bonds, and overseas bonds (that is bonds in a different currency from the policy's currency) where these offer better value and/or suit our liabilities better after taking account of risk. We select a mix of short and long-term bonds that takes account of the likely future incidence of guaranteed payments on policies.
- we allocate the rest of the assets primarily between equities and property partly to have a spread of asset classes, but we also consider where the best long-term value is likely to be achieved and take account of liquidity and marketability factors
- our equity holdings include local investments, (that is, in the same currency as the policy's currency) and overseas equities. This enables us to get exposure to other economies, sectors and stocks, and in this way we can enhance returns and reduce risk through diversification.
- our UK equities are invested primarily in companies represented in stock indices, for example the Financial Times – Actuaries All Share index. We start from a position of holding company shares in the same mix as the index, and may deviate from this within a set of tolerances when we consider it appropriate.

- our equities in other countries are similarly selected by reference to indices for that country or region or to world indices.
- we sometimes invest in assets that would not normally be traded as part of the diversified portfolio for specific reasons such as tax structures or access to particular areas, but restrict this to a small proportion of the total assets
- we follow a credit risk policy that restricts holdings to any one counter-party to reduce the risk of loss if a single counter-party defaults, and which sets benchmarks for the credit ratings for investments in each asset type.

We produce a With-Profits Investment Factsheet for the Clerical Medical With-Profits Fund which includes information on the latest allocation of assets.

Decision procedures

The investment strategy is kept under review, and is formally reviewed once a year by the Board.

The Board ensures regular monitoring of the policy and performance of fund managers through an Investment Strategy Committee. This committee includes executive and non-executive representation, and meets regularly to review Fund performance, market developments and any changes required to the investment strategy.

It is this committee that would review any proposed investment in new investments that materially change the nature of assets or risks or are not covered by existing policies.

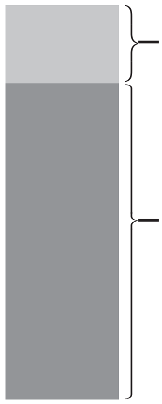
MANAGEMENT OF THE OPERATION OF THE FUND

We run the Fund prudently to help the company meet the guarantees it provides on with-profits policies.

The Clerical Medical With-Profits Fund is kept separate from the funds supporting other policies (the Scottish Widows With-Profits Fund and the Combined Fund).

We can choose how we operate the Fund, subject to the principles and practices described in this document. We run the Fund for the benefit of the policyholders and, where the operation of the Fund affects both policyholders and the company, we aim to ensure that both are treated fairly. We have a formal framework to ensure that this happens.

The Fund consists of two parts, as the diagram opposite shows. We aim to run with-profits in such a way that the estate continues to provide sufficient support and the company can meet the guarantees it provides. At least once a year, we determine whether the estate is more than is needed to meet the aims of prudent management of the Fund. Following a review of the amount needed to support the Fund, a distribution of excess estate was started from 1 February 2010.



The estate: assets held to support payouts in adverse scenarios, for example to support temporary smoothing deficits, and for guarantee costs not charged to policies.

Asset shares: the amount resulting from investing premiums less deductions, used as the principal factor for determining each policy's share of the Fund.

Principles

Uses of the estate

We can only operate with-profits if we have additional reserves of money that provide a cushion against adverse conditions such as a fall in stock market values.

The estate is held to support current and future policies in the Fund.

The estate allows our investment managers to invest substantially in higher-risk assets such as company shares, and helps to ensure that the Fund can meet its guarantees on existing and future policies.

The estate also ensures that the Fund can support smoothing. The smoothing process generates surpluses in the Fund during some periods and deficits at other times. The estate allows the Fund to support the deficits until surpluses cancel them out.

Assets held outside the Fund

The company holds assets outside the Clerical Medical With-Profits Fund. These assets help ensure the solvency of the company and, if necessary, help ensure that it can meet guarantees on with-profits policies.

Practices

Prudent management

The Board ensures that actions are taken to preserve the continuing viability of the Fund, taking advice from its risk managers, its actuaries, including the With-Profits Actuary, who take account of:

- the nature and terms of the guarantees on all the policies in the Fund
- the possible impact of those guarantees on the Fund and the company under a variety of different business and economic scenarios
- the resources available to manage the risks
- the expectations of policyholders.

Assets held outside the Fund

In most circumstances payouts are met from the Fund. However, the with-profits policies can rely, in extreme circumstances, on those assets of the company which are held outside the Clerical Medical With-Profits Fund.

If it looks likely that a deficit may arise in the Clerical Medical With-Profits Fund, a loan will be made to the Fund up to the level of the assets held by the company outside the Fund, and outside the

Aims of prudent management

We aim to control the guarantees given by the Fund to ensure that the company can meet the total guarantees at any time.

We aim to run with-profits in such a way that the estate continues to provide sufficient support and the company can meet the guarantees it provides.

In order to manage the level of the estate, we:

- aim to ensure that we do not over-commit ourselves to promises to pay on new and existing policies. We do this by regulating the volume of, and guarantees under new business, and the amounts of regular bonus added that increase the guarantees on existing policies
- strike a balance between the guarantees we give and the percentage of the Fund in higher-risk assets such as company shares, which tend to produce better returns over longer periods. However, our policy is to have a significant proportion in higher-risk assets with the aim of enhancing the investment return, and so we have to be careful to limit the guarantees
- moderate the pace of estate distribution, striking a balance between distributing excess estate to exiting policyholders whilst ensuring sufficient estate remains to safeguard the security of remaining policy benefits.

The costs and benefits of guarantees and smoothing would normally be met amongst the asset shares of the policies over time. However, in particularly extreme adverse market conditions, the costs of smoothing or guarantees could lead to a permanent transfer to the policyholders' asset shares, firstly from the estate and secondly from the assets held outside the Fund.

Scottish Widows With-Profits Fund, to the extent needed to prevent a deficit arising. A deficit will be considered to be likely if at any time projections over a two-year period indicate that there are insufficient assets in the estate to support payouts during that period that are not met from the relevant asset shares in accordance with this PPFM and policy terms and conditions.

Decision framework and process

The Board discharges its responsibilities through the use of committees, including committees of the Insurance Business of Lloyds Banking Group, and executives within the company. Relevant committees ensure regular monitoring and control of business risks. Business risks include insurance, market, credit, and liquidity risks. The committees regularly monitor the impact of these risks on the financial position of the Fund and, if needed, ensure that actions are taken to control the risks.

Adding to guarantees in the Fund

In deciding on regular bonus additions, we set the rate lower than the total expected returns, because where guarantees apply the bonuses cannot be taken away after they have been added. We set the rate at a level that:

- is sustainable in the long term (if necessary, by reducing the rate over a number of years to a sustainable level)
- is prudent in relation to the financial resources of the Fund
- is unlikely to force us to reduce the proportion in higher-risk assets of the assets backing asset shares
- is in all reasonably foreseeable circumstances, certain to be met by the assets of the company.

We monitor the volume of new business. If volumes of new business look likely to exceed the Fund's capacity, we would, subject to policy conditions, limit the volume of new business or seek to provide additional capital to increase the Fund's capacity for new business. New business is currently restricted as noted under "Arrangements on low levels of new business or closing to new business" on page 33.

Management of smoothing surpluses and deficits

We run a smoothing account that records the amount of smoothing surpluses and deficits arising over time on payouts on policies. To help support our aim of ensuring that the Fund continues to be well equipped to react to a range of investment conditions, we ensure that smoothing surpluses (when payouts have been less than the corresponding asset shares) and deficits (when payouts have been greater than the corresponding asset shares) do not affect the estate. We do this by spreading the cumulative smoothing surplus or deficit over the asset shares of all the remaining policies in the Fund. We do this every six months in arrears.

Management of guarantee costs

We currently intend to charge to asset shares no more than 1% in any one year, but this is not a guarantee. In very adverse conditions, the costs may be more than this. If this happens, we may limit the deductions from policies for guarantee costs, which could lead to a permanent transfer of an amount from the estate to policyholders' asset shares; or we may have to deduct more than this to ensure that guarantees are met across the Fund. We are currently deducting less in respect of premiums paid after 1 January 2008 than for premiums paid before 1 January 2008, but this may not continue in the future. The estate will pay any guarantee costs which are in excess of the sums deducted from policies.

We have bought derivatives in the estate to protect the Clerical Medical With-Profits Fund from some of the risks that would cause guarantee costs to increase in adverse investment scenarios.

Some older pension policies were sold with a guaranteed minimum annuity rate at retirement if the policy proceeds are used to buy an annuity. Effectively, this provides an interest rate guarantee, which is expensive if interest rates fall. We have bought derivative contracts to protect the Clerical Medical With-Profits Fund from most of the increase in the costs of these guarantees that would arise if interest rates fall.

These derivatives are not included in the assets used to help calculate asset shares: the only impact on asset shares is that any surplus or deficit arising when a derivative contract is sold or matures is used to adjust the costs of guaranteed annuity rates that are deducted as they are incurred across the asset shares of the policies in the Clerical Medical With-Profits Fund.

Excess estate

At least once a year, we determine whether the estate is more than is needed to meet the aims of prudent management of the Fund. This takes account of the amount we believe is needed to support the Fund, both the guarantees and any amount required for policyholders' interests or security.

We allow for:

- the findings of our financial and risk reports, especially the Fund's projected financial position under a wide variety of reasonably foreseeable assumptions
- both existing business in the Fund, and the latest plan and forecast of future new business
- what is needed to meet the company's reserving requirements, including capital needed to cover all reasonably foreseeable adverse conditions
- any need to enhance the current financial strength of the Fund
- what is needed to support the current proportion in higher-risk assets, or any planned increase in that proportion
- the principles and practices of the current PPFM

If there is more than is needed to support the Fund, we will distribute it. Any decision about how to distribute it, is made at the sole discretion of the Board, taking into account the legislation and regulation at the time, our previous statements about how we run the Clerical Medical With-Profits Fund, and the current Scheme of Transfer.

Following a review of the amount needed to support the Fund, a distribution of excess estate was started from 1 February 2010. This is being done by additions to asset shares, to the extent that it is prudent. Any addition to asset shares results gradually in higher levels of final bonus added on payouts than would otherwise apply, or lower MVRs where they apply.

We review periodically the level of estate against what is needed. There may be times when we can increase the amount being transferred to asset shares, but there may be times when we have to reduce it and possibly transfer back some or all of what has been previously added to asset shares.

Investment management of the estate

The investment strategy differs between the assets backing asset shares, and the other assets in the Clerical Medical With-Profits Fund collectively known as 'the estate'.

We have a more cautious investment strategy for the estate, including that part of the estate which is being added to asset shares, than we do for the assets backing asset shares. This strategy is to invest in assets such as cash deposits and UK government bonds. It helps keep the value of the estate stable, which in turn allows us to keep a significant proportion of the assets backing asset shares invested in higher risk assets.

Fund separation

The Clerical Medical With-Profits Fund is kept separate from the funds supporting other policies. The company comprises the Combined Fund, the Scottish Widows With-Profits Fund and the Clerical Medical With-Profits Fund. The Clerical Medical With-Profits Fund is where the profits of the Clerical Medical with-profits policies are earned. This Fund contains the assets backing asset shares and the assets held by the estate. For unitised with-profits business, premiums are paid into the Combined Fund, and the allocated part of each premium is passed to the Clerical Medical With-Profits Fund, as determined by the policy conditions.

For all unitised policies sold since 1996, when Halifax (now part of the Lloyds Banking Group) took over Clerical Medical (now Scottish Widows Limited), we have operated a '100/0' structure. This means that you pay explicit charges, which are clearly shown on the illustration you receive when you make an investment into the Clerical Medical With-Profits Fund. Lloyds Banking Group, as our shareholder, is entitled to receive these charges and no more, except when the annual management charge may be increased under the terms of a policy.

A different structure applies to policies started before 1997, but this does not affect the performance of policies started after then. See page 35 for the variations for other types of policy.

There is no division of the estate between groups of policies.

Fund separation

The Clerical Medical With-Profits Fund is kept separate from the fund supporting other policies (the Scottish Widows With-Profits Fund and the Combined Fund), although currently it holds a small amount – less than 0.5% by value – of other policies.

Types of policy in the Clerical Medical With Profits Fund

The company runs two distinct and separate With-Profits Funds, namely the Clerical Medical With-Profits Fund and Scottish Widows With-Profits Fund. This PPFM only relates to the different types of with-profits policies that are supported by the Clerical Medical With-Profits Fund.

For the Clerical Medical With-Profits Fund we have a number of separate groups that we call 'bonus classes'. Different bonus classes may have different rates of regular bonus, final bonus and market value reduction.

Types of policy in the Fund

Most policies in the Fund were sold by Clerical Medical (now Scottish Widows Limited).

A significant proportion of the policies in the Fund have been sold outside the UK.

Sub-division of the Fund

The Clerical Medical With-Profits Fund is notionally sub-divided for some purposes:

Setting bonuses
Different groups of assets within the Fund may be used to help set bonuses for different groups of policies.

Investment management
Different groups of assets within the Fund may be managed separately. Plainly, there will be a close alignment with the groups of assets used for setting bonuses, but the groups may not be exactly the same.

Meeting guarantee costs

For most policies, any charge for meeting the costs of guarantees is spread across all with-profits policies, but we may charge a different level of deduction to different groups of policies. This is based on our understanding of current law, which may change.

However, for certain other policies, regular deductions are made in advance to cover guarantee costs; examples are given in the section on variations for other bonus classes on page 35.

Exceptional costs

If the company incurs any compensation costs as a result of the selling and administering of policies, the costs are not borne by the Clerical Medical With-Profits Fund. The only exception to this is costs arising from activities before January 1997 when Clerical Medical (now Scottish Widows Limited) demutualised.

If the company incurs exceptional costs related to the operation of the Clerical Medical With-Profits Fund, over and above the cost of selling and administering policies, it may charge the costs to the Clerical Medical With-Profits Fund, funding the costs from the estate.

Arrangements on low levels of new business or closing to new business

If the level of new business into the Fund is low, or if the Fund were to be closed to new business, the estate would continue to be used to support the operation of the fund, allowing the same principles and practices to be applied to the policies remaining in the Fund as would have been applied if the level of new business were higher.

It is possible that the Fund could be re-opened to new business at a later date. Otherwise, with few new policies being issued, the numbers of policies will reduce over time.

Arrangements on low levels of new business or closing to new business

We currently allow new business in the Fund, after taking into account the reasonable expectations of all the policyholders in the Fund, and the impact on all policies in the Fund.

New business in the Fund is currently limited to:

- additional investment where existing policies allow it, including investment for new members of group schemes
- where pension policies issued in Germany and Austria allow a with-profits annuity to commence on retirement.

With little new business coming into it, the Fund will reduce in size over time, and we periodically review the level of the estate needed to meet the aims of prudent management of the Fund.

Whilst it is likely that the current low level of new business will continue into the future, it is possible that the level could increase at a later date.

Merger of Closure of the Fund

The Clerical Medical With-Profits Fund may close or merge with the Scottish Widows With-Profits Fund, if it (or either fund in the case of merger) falls below £500m in value (which is not expected to occur until 2035 or later). The fund will be merged or closed only if it is expected that there would be no material adverse impact on the benefit expectations of holders of with- profits policies. A certificate from an independent actuary and non-objection from our regulators would be required.

Formal framework and controls

We have a formal framework to ensure that we operate fairly.

We have a With-Profits Committee which usually meets separately from the Board. It considers any significant transactions and issues that could cause a conflict between different classes of policyholder or between policyholders and the shareholder, and makes recommendations to the Board that aim to ensure that the interests of both parties are dealt with fairly.

The Scheme

When Clerical Medical demutualised at the end of 1996, transferring its business to Halifax, a Transfer Scheme document specified certain rules governing the operation of the Fund. This original Transfer Scheme has now been superseded by a new Transfer Scheme, which transferred seven other UK life insurance companies (all subsidiaries of Lloyds Banking Group) into Clerical Medical. The new Transfer Scheme materially preserves the rules governing the operation of the Fund as laid out in the original Transfer Scheme. At the same time Clerical Medical was renamed Scottish Widows Limited.

The latest Transfer Scheme was approved by the English High Court of Justice, and those rules are legally binding, although the court could sanction a variation. All such rules are allowed for in this document.

Changes to principles

Any changes to these principles are approved by the Board on the advice of the With-Profits Committee and the With-Profits Actuary.

Formal framework and controls

We have a With-Profits Committee, which usually meets separately from the Board. None of the Committee's members has any management or executive role with the company (or its parent company Lloyds Banking Group). One of the members is a non-executive director of the company. The terms of reference of this committee can be found on Clerical Medical's website.

VARIATIONS FOR DIFFERENT BONUS CLASSES

The previous sections describe how *unitised* with-profits policies taken out after 1996 work. (These are the main UK bonus classes sold since demutualisation.) The following pages describe variations for other types of policies, which are supported by the same Clerical Medical With-Profits Fund as post-1996 unitised business, but work differently.

Each bonus class is managed according to the same principles and practices as the main UK bonus classes, except for certain variations under each of the headings used in the previous sections. The following table lists the bonus classes and the variations. Where there are no variations, the heading is omitted.

Bonus class	**Variation**
With-Profits Income Fund	Method for setting bonuses, investment strategy
Halifax Life pensions	Method for final payouts, MVR rates, eligibility rules for distribution of excess estate
Equitable Life pensions	Reinsurance arrangement, method for final payouts
NatWest Life (life and pensions)	Reinsurance arrangement
UK With-Profits Annuities	Bonus structure
Halifax Life With-Profits Annuity	Bonus structure, reinsurance arrangement
UK unitised with-profits sold before demutualisation	Deductions for expenses, treatment on demutualisation
Traditional business, sold before and after demutualisation	Expense deductions, treatment on demutualisation, shareholder's profits, guarantee deductions, mortality allowance in asset share calculations
Offshore With-Profits (OWP)	Currencies, investment strategy, reinsurance arrangement, eligibility for estate distribution
Pensions smoothed yield (GPC/DPP/EIPP)	Different interest structures, smoothing policy, surrender policy, guarantee deductions, expense deductions, eligibility for estate distribution, shareholder's profits
Passport Series	Bonus structure, smoothing policy, currencies, eligibility for estate distribution
Annuity With-Profits Funds (Germany and Austria)	Bonus structure, method for setting bonuses, charges and expenses, guarantee deductions, eligibility rules for distribution of excess estate, investment strategy.

Bonus class	Variation
With-Profits Income Fund	Method for setting bonuses, investment strategy

The amount payable under a with-profits policy

The With-Profits Income Fund aims to provide a relatively high income with as much stability of both income and capital as we can provide.

There are two types of bonus:

- a regular bonus, which is the level of 'income' paid out
- a possible final bonus, which we might add when you take money out. We normally review this twice a year, but we may need to change it at short notice if investment conditions change significantly.

Regular bonus rates

We set the regular bonus rate on the With-Profits Income Fund with the aim of paying a high level of 'income' with as much stability of both 'income' and capital as we can provide. We primarily take a view on the level of 'income' we expect from the Fund's assets in the coming year and beyond. However, we also make allowance for past growth on the Fund's assets and the future growth that we expect. If, looking ahead, we change our view on what we expect for the income or growth on assets, we change the regular bonus rate gradually each year to bring it in line with our expectations.

Final bonus rates

As most of the return on the Fund's assets is paid out as 'income', in the form of regular bonuses, the amount of final bonus is not expected to be large.

For an Income Bond, invested in the With-Profits Income Fund, your 'income' will vary each year depending on the bonuses declared each year. Your 'income' can fall as well as rise from one year to the next.

Please note: the word 'income' appears in inverted commas because for tax purposes HM Revenue & Customs treat it as a withdrawal of your capital. This is based on our current understanding of legislation and Revenue practice, which can change.

Investment strategy

The With-Profits Income Fund aims to provide a relatively high 'income' with as much stability of both 'income' and capital as we can provide.

The Fund will invest in a range of assets, which offer a high income yield, such as fixed interest and property.

Bonus class	Variation
Halifax Life pensions	Method for final payouts, MVR rates, eligibility rules for distribution of excess estate
Equitable Life pensions	Reinsurance arrangement, method for final payouts
NatWest Life (life and pensions)	Reinsurance arrangement

Reinsurance arrangement

Under reinsurance agreements, certain policies sold by Equitable Life and NatWest Life are allowed access to the Clerical Medical With-Profits Fund, possibly alongside other fund options. The Clerical Medical With-Profits Fund is completely separate from Equitable's with-profits fund, and the company has no liability for that fund.

In each case, the originating company passes a part of each premium on each policy to the company to be invested in the Clerical Medical With-Profits Fund. When an investor takes money out of with-profits, the company passes the amount payable back.

The company sets the bonus rates for the policies. In this way, the reinsured business shares in the profits earned in the Clerical Medical With-Profits Fund.

Method for final payout and final bonus

For some policies, regular premiums may be payable but all premiums are treated as repeated single premiums for the purpose of calculating smoothed asset shares and setting final bonus rates. This includes pensions policies originally sold by Halifax Life and Equitable Life pensions policies.

MVR rates

For most bonus classes, MVR rates currently vary with the start date to reflect more closely the individual policy returns. However, for pensions policies originally sold by Halifax Life and with regular premiums payable, a flat rate is currently used for all durations.

Eligibility rules for distribution of excess estate

If you have an existing single premium policy that was in force as at 1 January 2011 and make an additional investment, the additional investment will be eligible for any extra bonus amount relating to this estate distribution when you take money out of a with-profits policy.

If you switch from another fund into with-profits after 1 January 2011, the investment will be eligible for any such extra bonus amount.

If you decide to take benefits later than your pension date as stated in your policy certificate, you will be eligible for any extra bonus amount on your policy before and after your pension date.

Bonus class	Variation
UK With-profits annuities	Bonus structure

The amount payable under a with-profits policy

Each year, on the anniversary date of your policy, we will add the following to your basic income for the coming year:

- a regular bonus. Any regular bonuses added are carried forward each year
- a possible extra bonus. This will be paid for the coming year only, and might go up or down at the next anniversary date. We use the term 'extra bonus' because an annuity does not have a final payment. In the rest of this document, the term 'final bonus' applies also to the 'extra bonus' for the Invested Annuity.

For more detail please see the explanatory guide for the Invested Annuity.

If you have an Invested Annuity invested in the Invested Annuity Clerical Medical With-Profits Fund, your income will vary each year depending on the bonuses declared each year. Your annuity income can fall as well as rise from one year to the next.

Bonus class	Variation
Halifax Life With-Profits Annuity	Bonus structure

The amount payable under a with-profits policy

Each year, on the anniversary date of your policy, we will add the following to your basic income for the coming year:

- a regular (or 'annual') bonus. Any regular bonuses added are carried forward each year.
- a possible final (or 'terminal') extra bonus. This will be paid for the coming year only, and might go up or down at the next anniversary date.

For more detail please see the explanatory guide for the with-profits annuity.

If you have a Halifax Life With-Profits Annuity, your income will vary each year depending on the bonuses declared each year. Your annuity income can fall as well as rise from one year to the next.

Bonus class	Variation
UK unitised with-profits (UWP) policies sold before demutualisation	Deductions for expenses, treatment on demutualisation

Charges and expenses

Unitised with-profits policies sold before demutualisation at the end of 1996 work in exactly the same way as later policies, as described in the main PPFM, but with one exception.

The exception is the deduction from asset shares as a percentage of the fund. The deduction made for policies sold since 1997 has been the Annual Management Charge stated in the product literature. The deduction made for policies sold before 1997 has been at a lower level than that charged for unitised policies not invested in with-profits, reflecting the lower level of investment expenses as a percentage of the Fund.

Pre-demutualisation policies

Unitised policies started before 1 January 1997 were credited with a special bonus on 1 January 1997, and the asset share is credited with an extra percentage amount each year, which is funded from an amount which Halifax paid at the time of demutualisation. This is reviewed periodically to ensure that the amount Halifax paid to fund the additions is spread evenly over the lifetime of the policies.

Bonus class	Variation
Traditional business, sold before and after demutualisation	Expense deductions, treatment on demutualisation, shareholder's profits, guarantee deductions, mortality allowance in asset share calculations

Traditional policies includes both endowment and whole life policies, and pensions policies – Personal Pension Contract and Selective Pension Plan. Traditional policy classes are no longer sold.

The amount payable under a with-profits policy: asset share calculations

Charges and expenses: Unlike unitised business, there are no stated deductions for charges. Instead, we deduct an amount to cover the expenses of running traditional policies including investment management expenses, when we are calculating bonuses. We review the level each year to reflect our actual expenses, and periodically check that the deductions are not out of line with comparable rates charged by other companies.

Guarantee costs: For policies started before 1 January 1997, 2% of the premium has been deducted from premiums paid before 1 January 1997. This deduction is to pay for the guarantees. There will be no further charge for guarantees from the asset share in respect of these premiums; this applies only to the premiums paid before 1 January 1997.

Surrender profits: An addition for surrender profits was included in asset shares in the 1980s, but surrender profits have not been significant since then and no additions have been made.

Life cover: For endowments and whole life, the cost of life cover is a deduction from asset shares, based on recent experience of mortality rates.

Combined bonus rates: For endowments and whole life policies, we do not set bonuses with direct reference to the asset share of the policy. Instead, we combine the bonuses calculated for endowments and whole life policies in to a single percentage. We do it in a way that does not lead to an increase or reduction in the expected total payouts.

Regular bonus rates

A regular bonus is normally added to policies once a year, and a final bonus may be added when money is paid out. The bonuses are added to the 'basic amount' (the name for this varies with the product, for instance the sum assured on an endowment policy) to form the total payout. Once we add regular bonus, it is guaranteed in certain circumstances. The policy documents will give you more details of the guarantees that apply.

The regular bonus is declared in arrears. An interim rate is declared in advance and used in calculating any final part-year's entitlement to regular bonus in amounts paid out during the year.

Final bonus rates

Interpolation of whole-year final bonus rates is used to give credit for additional whole months. For traditional policies, interpolation is between the final bonus rate applying on the previous renewal date and the final bonus rate expected to apply on the next renewal date. This is done to help ensure fairness, by using the final bonus rates that are appropriate for a policy's basic amount: the calculation of the basic amount depends on when the policy started.

Surrender values

We pay a surrender value if you cash in your policy in circumstances when guarantees do not apply. As for other payouts, we aim to pay amounts that are within 20% of the asset share. We expect to achieve that aim most of the time and for at least 90% of policies, but we may not achieve it all the time. We review the level of surrender values at least once a year, and if necessary change the basis.

Shareholder's profits

For traditional policies started after 1 January 1997, Lloyds Banking Group is entitled to receive up to one-ninth of the value of bonus payments as shareholder's profits, and a deduction is made from asset shares to allow for this. This is calculated using a method that is consistent with the regulatory valuation. The terms of the transfer of business to Halifax ensure that no deduction is made for those with-profits policies started before 1997. Tax on these profits is paid by the shareholder.

Formal framework

The framework for ensuring we operate with-profits fairly is described in the main Principles, and applies to all aspects of with-profits, including the special features of traditional business such as the deductions for expenses.

Pre-demutualisation policies

The treatment of traditional policies differs between those started before and after 1 January 1997, when Halifax took over Clerical Medical (now Scottish Widows Limited). Policies started before 1 January 1997 were credited with a special bonus on 1 January 1997, and the asset share is credited with an extra percentage amount each year. The percentage is reviewed periodically to ensure that the amount Halifax (now part of Lloyds Banking Group) paid to fund the additions is spread evenly over the lifetime of the policies.

Bonus class	Variation
Offshore With-Profits (OWP)	Currencies, eligibility for estate distribution, investment strategy, reinsurance arrangement

Policies invested in OWP are available in a number of currencies: sterling, US dollar and euro. Policies invested in OWP have been sold into the UK and outside the UK.

Eligibility for estate distribution

If you have a policy that was started before 1 January 2011 which offers a choice between sterling, dollar or euro with profits funds, you will be eligible for the extra bonus amount from the distribution of excess estate started on 1 February 2010 if you switch from one currency to another. You will not however be eligible for any extra bonus amount for the period in the new currency with-profits fund after you've switched.

Investment strategy

OWP policies are sold in US dollar and euro currencies as well as sterling, and separate groups of assets are used for each currency. The assets for each currency have a similar mix of fixed-interest and higher-risk assets, but there are two differences:

- most of the assets are in the same currency as the OWP policy and are invested in the investment markets of that currency area
- the proportion of assets in property varies between each OWP currency.

Reinsurance arrangement

Under a reinsurance agreement, RL360 Life Insurance Company Limited ('RL360') passes a part of each premium on each policy to the company to be invested in the Clerical Medical With-Profits Fund. When an investor takes money out of with-profits, the company passes the amount payable to RL360. In this way, RL360 policies invested in OWP share in the profits earned in the Clerical Medical With-Profits Fund.

Bonus class	Variation
Pensions smoothed yield	Different interest structures, smoothing policy, surrender policy, guarantee deductions, expense deductions, eligibility for estate distribution, shareholder's profits

This business has been called 'deposit administration' business. These classes of business are closed to new business or have very little new business. Each of the three types of contract has a different interest rate structure, as shown in the table below.

Interest rate structure		
	Added to the fund	Added to claims (akin to final bonus)
Group Pension Contract (GPC)	Basic Yield Equity Addition High Interest Addition	Claim Addition
Directors' Pension Plan (DPP)	Current Interest	Retirement Addition
Executive Pension Contract (EIPP)	Interest on generational pools	N/A

The amount payable under a with-profits policy

Regular bonus rates

Final bonus rates

Smoothing

The interest rate policy is designed to reflect the performance achieved on the assets applicable to these policies, with a substantial degree of smoothing. For each of the three products, we set interest rates with regard to the distributable performance of the Fund available for the whole portfolio of business, rather than the performance attributable to individual policies. This means that there is greater sharing of performance between individuals over different investment periods. This method is sometimes known as a 'mixed money' basis. It means that, whilst like other policies we aim to pay amounts that are within 20% of the asset share, this is for the portfolio of policies as a whole.

For Group Pension Contract, the basic level of interest is called the 'Basic Yield'. 'Equity Addition' is used to adjust the Basic Yield interest to a level that better reflects the performance achieved on the assets, with a substantial degree of smoothing. High Interest Addition applies when gilt yields are high. For Group Pension Contract and Directors' Pension Plan, Claim Addition and Retirement Addition are added to claims to top up the amount already distributed by the other additions to a fair level. Executive Pension Contract has a single interest rate structure, which is less reactive to large market movements than is a structure with two or more tiers of bonus/interest as for most other bonus classes, and this could lead to more occasions when payouts are more than 20% away from asset share.

Eligibility to estate distribution

All current and future monies invested in Group Pension Contract are eligible to share in the estate distribution that started from 1 February 2010.

Charges and expenses

Unlike unitised business, there are no stated deductions for charges. Instead, we allow for the expenses, including investment management expenses, of the policies when we set interest rates, which vary depending on the size of the scheme. We review the level each year to reflect our actual expenses, and periodically check that the deductions are not out of line with comparable rates charged by other companies.

For Group Pension Contract and Directors' Pension Plan, a deduction is made each year for the guarantees, and there will be no further charge for guarantees arising from other classes of business.

Shareholder's profits

The Lloyds Banking Group is entitled to receive as shareholder's profits 1% pa of the fund for policies started before 1 January 1997. The terms of the Transfer Scheme ensure that there are no policy deductions for this. Tax on these profits is paid by the shareholder.

Formal framework

The framework for ensuring we operate with-profits fairly is described in the main Principles, and applies to all aspects of with-profits, including the special features of this business such as the deductions for expenses.

Bonus class	Variation
Passport Series	Currencies, bonus structure, smoothing policy, eligibility for estate distribution

Passport Series policies are available in a number of currencies: sterling, US dollar and euro. The policies have been sold outside the UK, and are no longer open to new business. This business has been called 'smoothed yield' business.

Passport Series currently has a single tier of bonus, the 'Fund Addition'. We review it twice a year, on 1 January and 1 July.

The amount payable under a with-profits policy

Regular bonus rates

Smoothing

The bonus rate policy is designed to set the Fund Addition rate at a level supportable in the future and to reflect the performance achieved on the assets applicable to these policies, with a substantial degree of smoothing. We set Fund Addition rates with regard to the performance of the Fund available for the whole portfolio of business, considered separately for each currency, rather than the performance attributable to individual policies. This means that there is greater sharing of performance between individual policies over different investment periods. This method is sometimes known as a 'mixed money' basis. The single bonus rate structure is less reactive to large market movements than is a structure with two or more tiers of bonus as for most other bonus classes, and this could lead to more occasions when payouts are more than 20% away from asset share.

Investment strategy

The proportion in company shares is lower than for UK business. The policies are sold in US dollar and euro currencies as well as sterling, and separate groups of assets are used for each currency. The assets for each currency have a similar mix of fixed-interest and higher-risk assets, but there are two differences:

- most of the assets are in the same currency as the Passport Series policy and are invested in the investment markets of that currency area
- the proportion of assets in property varies between each Passport Series currency.

Eligibility for estate distribution

If you have a policy that was started before 1 January 2011 which offers a choice between sterling, dollar or euro with profits funds, you will be eligible for any extra bonus amount from the distribution of excess estate started on 1 February 2010 if you switch from one currency to another. You will not however be eligible for any extra bonus amount for the period in the new currency with-profits fund after you've switched.

Reinsurance arrangement

Under a reinsurance agreement, RL360 Life Insurance Company Limited ('RL360') passes a part of each premium on each policy to the company to be invested in the Clerical Medical With-Profits Fund. When an investor takes money out of with-profits, the company passes the amount payable to RL360. In this way, RL360 policies invested in Passport Series share in the profits earned in the Clerical Medical With-Profits Fund.

Bonus class	Variation
Annuity With-Profits Funds (Germany and Austria)	Bonus structure, method for setting bonuses, charges and expenses, guarantee deductions, eligibility rules for distribution of excess estate, investment strategy

These with-profits annuities arise from certain deferred annuity insurance policies written in Germany and Austria when income benefits are taken on retirement or as a result of an earlier death. They are available in Euro currency only. In the period before the annuity starts, any investment in the Clerical Medical With-Profits Fund is through a GGF bonus class (please refer to "Management of the payouts on policies (Guaranteed Growth Funds)" page 13).

This section applies to the with-profits annuities once income benefits are taken.

The amount payable under a with-profits policy

Regular bonus rates

Each year, on the anniversary date of a policy, we may add an annual bonus to the policy benefits. The total annuity amount paid in a year consists of the basic income, which is set when the annuity starts, and the accumulated annual bonuses. There are no final bonuses.

Different types of annuity may have different guarantees. The guarantee applying to your annuity is described in your policy documents. If you have a 'Guarantee Option 100%' annuity the total annuity amount will not reduce from one year to the next. The 'Guarantee Option 75%' may also be available for selection at retirement. If you have a 'Guarantee Option 75%' annuity the basic income anticipates a certain rate of annual bonus and so it reduces from one year to the next; the total annuity amount may therefore reduce from one year to the next depending on the actual rate of annual bonus added. For more detail please see the policy conditions for your annuity.

Annual bonus rates are calculated with the aim of exhausting the assets associated with a group of annuities over the remaining lifetime of the annuities, whilst maintaining a similar rate of annual bonus in future years. The rates therefore depend on the investment performance of the assets and the life expectancy of annuitants as a group projected by the company on the advice of its actuaries.

The initial level of the annuity is set on the basis of a certain assumption of life expectancy at the time. If over time life expectancy increases, this will lead to lower annual bonus rates than would otherwise have been the case. Conversely, reduced life expectancy will, other things being equal, lead to higher annual bonus rates. In poor investment conditions or if there is a large increase in life expectancy, the annual bonus rate may be very low or zero.

Annuities are grouped together depending on the start date of the annuity, and the rate of annual bonus may differ between such groups of annuities.

Charges and expenses

There are no deductions for administration expenses, other than the charges described in the policy conditions, and the costs related to buying, selling and holding assets.

Guarantee costs

When the annual bonuses are calculated, deductions may be made to allow for the guarantees provided across the portfolio of Annuity With-Profits Funds.

Eligibility for distribution of the excess estate

These annuities are not eligible to share in the distribution of the excess estate started from 1 February 2010. Any changes in eligibility criteria for sharing in this or future distributions will be announced by the company at the time.

Investment strategy

The assets are predominantly in fixed-interest investments of similar terms to the future annuity payments. This helps to ensure that the annuity amounts, including annual bonuses added in previous years, can be paid over the lifetime of the annuities. A proportion of the assets may be invested in higher risk assets such as company shares and property.

The performance of these higher-risk assets is an important factor in determining whether the rate of annual bonus increases or reduces from year to year. Over the lifetime of annuities as a group, the proportion in higher-risk assets may be expected to reduce gradually, but this will depend on investment conditions and trends in life expectancy. The proportion in higher-risk assets will reduce faster if investment conditions are adverse or if life expectancy increases. This may result in the proportion in higher-risk assets reducing to zero, and even staying at zero for the remaining lifetime of the annuities.

www.clericalmedical.co.uk

Clerical Medical is a trading name of Scottish Widows Limited. Scottish Widows Limited is registered in England and Wales No. 3196171. Registered office in the United Kingdom at 25 Gresham Street, London EC2V 7HN. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Financial Services Register number 181655.

X1813/0817