

Report to Clerical Medical UK With-Profits Policyholders

Report on Principles and Practices of Financial Management (PPFM) for 2017



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This annual report tells you how we have managed the Clerical Medical With Profits Fund in 2017. It explains how we have used our discretion in managing the Fund, and gives information about the Fund's investments and the returns the Fund has earned from them.

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

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

We have managed the With Profits Fund in line with our published principles and practices – our PPFM. The PPFM focuses in detail on the standards, methods and controls we use to ensure we run with-profits fairly. It also explains how we respond to changes in the economic environment.

You may find it helpful to refer to the 'With-profits summary' which summarises how we manage with-profits policies. This document can sometimes also be referred to as the 'CF PPFM' (customer friendly PPFM). The current version is also available on our website www.clericalmedical.co.uk

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

The Board of Scottish Widows Limited met on 22 March 2018 to consider the matters covered in this report including the statement provided by the With-Profits Actuary appended at the end of the report, and advice from the independent With-Profits Committee that it has reviewed the report and considers it appropriate for the Board to publish it. The Directors are satisfied that the Clerical Medical With Profits Fund has been managed in accordance with the PPFM in all material respects with all errors identified being corrected.

The Directors of Scottish Widows Limited
22 March 2018

1. Our Aim

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

- By making sure that when guaranteed minimum payments apply we pay at least those amounts to policyholders.
- By aiming to pay out a fair share of investment performance to with-profits policyholders (or any guaranteed amount, if higher).
- By aiming to achieve growth over the long term by having a significant proportion of the assets in higher-risk assets such as company shares and property, whilst ensuring that we can meet the With Profits Fund's guarantees.
- By aiming to smooth through some of the peaks and troughs of stock market values; and
- By adding regular bonus. We have to bear in mind that, where guarantees apply, we cannot take away regular bonuses once we have added them to your investment. This means that we set the rate lower than we otherwise might do, and that we may set regular bonus rates at zero.
- By moderating the pace of estate distribution to strike a balance between enhancing payouts for eligible policies and safeguarding the security of remaining policy benefits.

2. The Clerical Medical With Profits Fund in 2017

2.1 Investment returns over 2017

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

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

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

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

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

Against this background, of strong performance from equities and the increase in the value of sterling against the dollar, the Clerical Medical With Profits Fund produced an overall investment return on assets backing policies of 8% in 2017.

2.2 Investment policy

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

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

The Board reviews the strategic investment mix regularly. For asset shares, we choose the mix of assets with the aim of:

- getting the best possible long-term performance; and
- making sure that the with-profits fund can always meet its guarantees (also taking account of the assets in the estate).

In 2017 we:

- Reduced the fund's exposure to UK and Japanese equities in favour of Emerging Market equities. This continued the policy adopted towards the end of 2016 when Emerging Markets were identified as offering better value than Developed Markets.
- Purchased derivatives to protect the fund to downside risk from equity exposure.
- Continued to have only a relatively small proportion of the fund invested in UK government bonds based on their valuation being well above historical levels i.e. yields being historically low. As a result of this decision, a higher proportion of the fund is invested in cash deposits than normal.
- Increased exposure to absolute return funds. This asset class aims to generate a positive return, even in poor market conditions, and is seen as a good source of diversification.

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

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

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

- The strategy changes described above.
- Changes in the shorter-term positioning taken by the investment managers, which at the end of 2017 included an increase in cash and a decrease in allocation to both UK Government Bonds and Corporate Bonds (fixed interest bonds issued by companies).
- The relative movement in different markets (a strongly performing type of asset will tend to increase as a proportion of the fund naturally). Equities performed particularly well in 2017, especially Emerging Markets.

Asset Allocation	31-Dec-15	31-Dec-16	31-Dec-17
Fixed interest			
• UK government bonds	3%	6%	4%
• Corporate bonds	14%	12%	10%
Loans secured against commercial property	2%	3%	3%
Property	14%	12%	13%
Equity shares			
• UK shares	17%	18%	18%
• Non-UK shares	20%	24%	26%
Absolute Return funds*	12%	13%	14%
Other investments (mainly cash deposits)	18%	12%	12%

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

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

2.3 Regular bonuses

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

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

In most cases regular bonus rates were reduced slightly in February 2017, following a fall in government bond yields, which has reduced the expected future return. Regular bonus rates remain low in absolute terms in line with the approach described above. Regular bonus is only part of a policy's payout and final bonus may be added whether or not we are currently adding regular bonus to a policy (please see section 2.4).

2.4 Payouts in 2017 – final bonuses and market value reductions

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

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

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

Our final bonus rates and MVR rates have been kept under review, and have been changed in line with our published policy. We normally carry out reviews every six months, and did so at 1 February 2017 and 1 August 2017. As a result of these reviews the level of payouts increased for the majority of policyholders over 2017, (by c. 1.5% in February and c. 4% in August). This reflected market movements offset slightly by the application of smoothing, and a reduction in the level of distribution of excess estate (please see below). Our review at 1 February 2018 has reversed these small reductions.

Distribution of excess estate

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

We currently review the level of the estate against what is needed every six months. There may be times when we can increase the extra amount included in any final bonus due, but there may be times when we have to reduce it or possibly not pay anything extra at all. At the reviews in 2017 a decrease was made in both February and August, but the remaining distribution is still adding around 4% to payouts for fully eligible policies. You can check the extent to which your policy is eligible by looking at page 10 in the "With-profits summary" document.

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

Smoothing

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

To achieve this smoothing effect we look at investment returns your policy would have earned if it had started and finished up to two years earlier and up to two years later. When investment conditions experienced over the actual term of your policy are better than expected we keep back some of the returns when deciding on the final bonuses (which we normally do twice a year). When they have been less than expected we add to the returns when deciding the final bonuses.

To support our aim that the Clerical Medical With Profits Fund continues to be well equipped to react to a range of investment conditions, we aim to ensure that the impact of smoothing does not affect the estate. We make an adjustment that spreads the impact of smoothing over the asset shares of all the policies in the Fund. This adjustment is currently calculated every six months. The adjustments resulting from these reviews in 2017 had the result that asset shares were increased by 0.2% on 1 August 2017.

Guarantee Costs

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

We plan to deduct no more than 1% in any one year, but in very adverse market conditions we may have to deduct more than this to ensure that guarantees are met across the Clerical Medical With Profits Fund. The deduction applied in 2017 was 0.3% of asset share for premiums paid before 1 January 2008, and 0.1% for later premiums.

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

Target Ranges

The asset shares of specimen policies help us decide on the levels of final bonus and the payouts made when policies are surrendered. As stated in 'Your guide to with-profits', we aim that payouts fall within a specified range around asset shares for these specimen policies (ignoring distributions from the estate – please see section above titled 'Distribution of excess estate'). These ranges describe the maximum expected variation between the payout and asset share of a specimen policy. In practice the majority of payouts are clustered around 100% of asset share.

Based on representative specimen model points we regularly analyse the extent to which payouts may be distributed around asset shares for reasons other than the smoothing of investment returns (i.e. due to the grouping of policies). We separately monitor, at least weekly, the extent to which changes in investment markets are causing asset shares to move relative to our current payouts. By combining the results of those investigations and monitoring we are able to identify if payouts might be moving outside of the target ranges.

During 2017 all payouts on specimen policies were within the target range.

2.5 Administration costs

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

For non-unithised business there are no stated deductions for charges. Instead we deduct an amount to cover the expenses of running these policies including administration expenses, when we are calculating bonuses. We review the level each year to reflect our actual expenses on this block of business, and periodically check that the deductions are not out of line with comparable rates charged by other companies. One of these periodic checks was carried out in 2017 and confirmed that our charges are in line with other companies. The charges have been agreed by the Board on the advice of the With-Profits Actuary and are considered to be properly attributable to the Fund and to be fair and equitable.

2.6 With-profits policies issued to new customers

Over the last few years, the number of new customers investing in the Clerical Medical With Profits Fund has reduced. This reflects a general reduction in demand for with-profits policies in the insurance market. As a result we are no longer actively seeking new with-profits business. The number of policies is therefore reducing as they reach maturity, pension customers reach retirement and other withdrawals are made.

This does not change the prospects for our current with-profits customers or the protection offered by policies' guarantees and options. With-profits policyholders can expect to continue to benefit from a diversified investment policy and from the smoothing of returns (section 2.4 explains smoothing).

2.7 The role of the With-Profits Committee

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

Throughout 2017 the Committee comprised four members, none of whom have any management or executive role with the company (or our parent company, Lloyds Banking Group). One member is a non-executive director of the company. The terms of reference set out the responsibilities of the Committee, and can be found at: <http://reference.clericalmedical.co.uk/docs/E2088.pdf>

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

There are five main controls in place to ensure this:

- The scrutiny provided by our With-Profits Committee, which is described above in section 2.7.
- Whenever we make important choices that affect the way we manage our with-profits policies, our With-Profits Actuary, who advises the Board, presents a report for the directors giving the reasons behind the proposals and how these comply with the PPFM.
- Throughout the year, all the data, work and actions that supported our decisions have been recorded. The With-Profits Actuary has reviewed this evidence and is satisfied that the decisions were consistent with the PPFM, the Financial Conduct Authority (FCA) rules on Treating With-Profits Customers Fairly and the court-approved Scheme that governs the operation of the Clerical Medical With Profits Fund. He has stated that in his opinion the interests of policyholders have been taken into account in a fair and balanced way.
- The With-Profits Actuary has reported on this evidence to our With-Profits Committee covering the areas where decisions were made, and how they complied with the PPFM and with the rules of the Financial Conduct Authority relating to the fair treatment of with-profits customers.
- The With-Profits Committee also receives reports from our internal audit function, who review various aspects of our business and controls. Input from an independent actuary is also sought when appropriate.

Further information on with-profits:

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

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

You'll find copies of these documents and the latest information on bonus rates and MVRs on our website www.clericalmedical.co.uk

Statement from the With-Profits Actuary

In my opinion the discretion exercised by Scottish Widows Limited during 2017, and the report from the directors to which this statement is attached, have taken the interests of Clerical Medical with-profits policyholders into account in a fair and balanced way. I base this opinion on the information and explanations provided to me by the company, including information requested by me, and the relevant rules and guidance issued by the Financial Conduct Authority.

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

www.clericalmedical.co.uk

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