

How we invest your money

Our guide to the Scottish Friendly With-Profits fund

Introduction

This is a brief guide to the principles and practices of financial management (PPFM) by which we, Scottish Friendly Assurance Society Ltd, manage the with-profits business transferred from the Scottish Legal Life Assurance Society Ltd on 30 September 2007.

The premiums you pay into your Scottish Legal Life with profits policy are invested in Scottish Legal Life's notional with profits fund.

We have produced this guide to help you gain a better understanding of the way we manage this class of business and how we apply discretion – especially over the benefits payable to policyholders.

What are the key financial objectives?

We have five key financial objectives that can be regarded as governing the principles and practices of our financial management.

These are:

- To meet the contractual obligations to policyholders
- To treat all policyholders fairly and meet the reasonable expectations of with-profits policyholders
- To meet the required tests of solvency and capital adequacy as needed by regulatory bodies
- Over the term of the existing policies, to avoid holding back surplus in excess of that required to ensure the sound financial management of the fund and to distribute all of the surplus among with-profits policyholders
- Subject to the above, to maximise the financial returns to with-profits policyholders.

What is the PPFM?

The PPFM is a document describing how we manage our with-profits business. It is split into Principles and Practices.

Principles are high-level statements that describe our long-term approach to managing the business.

Practices are more specific statements that flow from the Principles. These describe how we currently manage the business.

We don't expect to change the Principles often, but we will do so if we think they could lead to policyholders being treated unfairly or if they could stop us managing the business properly. We must tell you at least three months in advance if changes are to happen. You will therefore know when and how we intend to change our long-term approach before it happens. Practices change more often because we need to respond to how the economy is doing, new rules and regulations, and new techniques in the life insurance industry. We will publish any changes to Practices on our website and tell you about them in our next letter to you. In this way we will let you know how our approach has changed.

The PPFM is a long and detailed document. This guide sets out only its key points. If there is any conflict in interpretation as between this document and the PPFM then the PPFM takes precedence.

In the following sections the Principles are marked in the guide by a square; Practices are marked by a diamond.

Types of With-profits Policies

There are two types of with-profits policies

- 'conventional' with-profits policies; and
- 'unitised' with-profits policies.

If your with-profits policy is a Special Tax Exempt Plan, a STEP Plus, a Mutual Investment Bond or a Flexible Savings Plan then the with-profits element is 'unitised', otherwise it is 'conventional'. If you have lost your policy or if you are unsure about the nature of your policy, please contact us.

- Under conventional with-profits policies, in return for your premiums, we pay a guaranteed lump sum (called a sum assured). We aim to increase the guaranteed amount by adding bonuses.
- Under unitised with-profits policies, premiums are used to buy units in the fund at the current unit price. We aim to increase the unit price by adding bonuses. To work out how much you get back, we use the value of the units allocated to your plan.

How does Scottish Friendly decide bonuses?

- We aim to provide investment returns under policies that have regard to the contribution that each policy makes and allow for the shared experience for the business as a whole.
- We aim to achieve a broad degree of fair treatment across different types, sizes and generations of policies in a way that does not require frequent reviews to bonus rates and surrender value bases.
- ◇ We also look at the level of guaranteed benefits on policies as compared to the asset share of policies. An asset share is a calculation which determines

how much a policy has contributed to the fund and how much profit or loss, on average, that policy has made. We calculate asset shares by:

- accumulating the premiums paid;
 - making deductions to cover our expenses, tax and the costs of providing benefits; and
 - adding the investment returns made by the policy.
- ◇ If the guaranteed benefits for a policy are higher than their asset share, bonuses may be small or zero.
- ◇ Asset shares are calculated for a sample of specimen policies and the results are used to determine bonuses for other similar policies.

Annual bonuses

- ◇ Annual bonuses on conventional policies are declared after the end of each calendar year. Annual bonuses on unitised with-profits business are declared through increases in the unit price from day to day. Once an annual bonus has been added, it increases the guaranteed amount on a policy and so can't be taken away.
- ◇ For both types of policy our aim is to declare bonuses at a rate that we consider to be sustainable in the future under expected investment conditions. We also aim to hold back profits with the intention to pay a final bonus.
- ◇ We do not aim to change annual bonus rates frequently and, in practice, rates only change when it can be clearly demonstrated that the current rate is either too large or too small.

Final bonuses

- Final (or terminal) bonuses may be paid to both types of policies when they end. We pay them to make sure that what you get back fairly reflects the investment performance and experience of the fund generally over the lifetime of the policy (to the extent that the annual bonuses we have paid you have not already achieved this).
- Rates of final bonus are reviewed at regular intervals. Nevertheless, further reviews may take place if economic conditions change rapidly and, without such a review, values would be unfair or threaten our financial stability.

What happens if you leave the fund early?

- ◇ If you surrender a conventional with-profits policy we will calculate the value payable using a formula that takes into account the guaranteed benefits payable and the anticipated time before such payment is due. The basis underlying the formula is designed to produce surrender values that are reasonably close to each policy's asset share.
- ◇ If you surrender a unitised with-profits policy the value will be based on the number of units held and the price of each unit on the day after your request

is received. The value of your with-profits units may be increased by a final bonus if this is paid. If a final bonus is not paid we may apply a Market Value Reduction (MVR). This reduction may be applied where the policy's value is in excess of its asset share. Charges or penalties will be applied in accordance with your policy's provisions.

What is smoothing?

- The values of the investments backing our with-profits business change from day to day and sometimes the change over a period of time can be very large. Asset shares, being linked to investment returns, will also change in line with investment values. However, the value you would receive from your policy does not change in line with daily investment price fluctuations.
- Similarly, a sudden large increase or decrease in investment values would not automatically affect policy values. This is because policy values are primarily affected by the bonuses we declare. Changes in bonus rates take place relatively infrequently and are more gradual than changes in investment market prices. This "smoothing" effect enables us to cushion you from fluctuations in the stockmarket.
- A consequence of smoothing is that you are likely to receive either more, or less, than the exact "unsmoothed" asset share underlying your policy. To limit any unfair advantage that a policyholder could take, we apply less smoothing in cases where a policyholder has more freedom to choose when to surrender his/her policy.

How does Scottish Friendly decide what the With-profits fund will invest in?

- The primary investment aims for our with-profits business are to match all guaranteed payments with appropriate assets and to maximise returns to policyholders beyond the guaranteed amount. Government and corporate bonds form the core assets backing with-profits liabilities that are used to match the guaranteed payments when they become due. The balance of the assets include property and local and foreign equities to maximise returns.
- We operate in both the UK and the Republic of Ireland and we must have regard to currency matching where appropriate.
- A broad spread of assets is held to reduce risk
- ◇ We normally review our investment strategy at least annually but may need to do so more often if market conditions change quickly.

What risks are the with-profits funds exposed to?

- ◇ The fund is exposed to a number of risks. Our biggest risks come from the need to pay all guaranteed benefits when they are due in the context of possible falls in equity or property values.
- ◇ We aim to minimise risks to the fund and our business by reducing our exposure to risk, for example, by ensuring investments are in line with the nature and term of the liabilities.
- ◇ We allocate the cost of risks to the inherited estate.

- Except for normal levels of investment risk resulting from managing the fund's assets, the fund will not take on any significant new risks. In particular, the fund is closed to all new business (although we do let existing policyholders amend their policy if this is allowed under their policy provisions).

What are the Charges?

- ◇ For unitised with-profits business, the charges for risk cover and management expenses (including investment costs) are defined in the policy provisions.
- ◇ For conventional with-profits business we do not make explicit charges but management expenses and the cost of life cover are allowed for within the asset share calculations.
- ◇ The management expenses are fixed as per the agreement for the transfer of Scottish Legal Life's business to Scottish Friendly

What the estate is and how do we use it?

- The estate is a realistic assessment of the excess of the with-profits fund's investments over the values of the policies in force.
- Following the closure of Scottish Legal Life to new business in May 2002, a key objective has been to distribute the estate to with-profits policyholders in a manner which is fair having regard to different classes, generations and country of origin of the business.
- The estate will be distributed to with-profits policyholders through the payment of higher claim values than would otherwise be the case. Our ultimate aim is for both the with-profits assets and liabilities to reduce to zero when the last claim is made.
- In managing the estate distribution, we will have regard to how we use it. Uses include supporting solvency, investment and bonus policy (including smoothing) and meeting certain expense or business risks. These purposes will also influence the size of the estate required from time to time. However, our aim is to limit the exposure to risk over time so that the fair distribution of the estate is not jeopardised.

Where can I get more information?

You can find additional information about the way in which your individual policy will invest in the With-Profits fund in the Key Features or policy document.

This document is a summary of the more detailed Principles and Practices of Financial Management for Scottish Friendly's With-Profits fund. Copies of this document are available on request from Scottish Friendly or simply by downloading it from the Scottish Friendly website.