



Report on Principles and Practices of Financial Management for 2007

1. Introduction

The purpose of this report is to explain how we have managed our with-profits fund in 2007. This includes setting bonuses and making investment decisions. The report shows the steps we have taken to ensure that we treat policyholders fairly and concludes that we have managed our with-profits fund in the way described in our Principles and Practices of Financial Management. You may also find it helpful to refer to 'Your guide to with-profits', which summarises how we manage with-profits policies. We provided a copy of that guide to all customers having with-profits policies in 2006, and to all new with-profits customers since then. It is also available on our website (www.scottishwidows.co.uk/wpguide).

2. Key areas where we make judgements in managing with-profits business

Our aim is to achieve fairness between different types and groups of with-profits policyholders, and between them and our shareholders. This is subject to any contractual, legal and regulatory constraints and the aim of safeguarding the solvency of the company. We believe fairness is achieved:

- By aiming to make payments to with-profits policyholders that overall reflect fair shares of the assets underlying their policies (we do this by tracking 'asset shares' for groups of policies and setting 'target payout levels', as explained in 'Your guide to with-profits' on our website and in question 3 below), and
- By making investment decisions that give our with-profits fund the potential to benefit from the higher rates of growth available from some investment types. For instance, in the long term, we expect a better return from investing in shares and property than from many other types of investment.

The payments made from our with-profits fund depend on the bonuses that we set. When we set bonus rates in 2007 we had three main goals in mind:

- i) being fair to all investors in our with-profits fund – both those whose policies are maturing now and those whose policies will mature in the future. Since with-profits policyholders are sharing in the same funds, paying out more to some now would involve paying less to others later. We also aim to ensure the payments to policyholders are consistent with what we have led them to expect;
- ii) cushioning with-profits policyholders from temporary stockmarket turbulence by "smoothing" payouts when policies mature; and
- iii) increasing the minimum guaranteed amount with-profits policyholders will receive when their policies mature – if we can do this without too great a risk to the financial strength of our with-profits fund or its freedom to invest. This strength and freedom are needed to make good investment returns possible for all policyholders into the future. For instance, we are able to invest a higher proportion of the fund in assets that we believe will produce a better return in the long term.

We also aim for fairness between our shareholders and policyholders. While we aim for all with-profits payments to be met from our with-profits fund, shareholder capital supports the financial strength of our with-profits fund and increases its investment freedom.



3. Frequently asked questions

The following questions and answers will explain how we applied judgement in 2007, including the bonus rates we set. They show how we have run the with-profits business in line with our Principles and Practices of Financial Management. Further helpful information can be found in the booklet called "Your guide to with-profits", which we provided to all customers having with-profits policies in 2006, and to all new with-profits customers since then. You can also find this guide on our website. If you have any further questions please contact us on 0845 845 0845.

Q1. What were investment returns like in 2007?

Investment markets generally offered lower returns in 2007 than in some recent years; for example the FTSE-100 index of equity shares increased by 3.8%, the so-called 'credit crunch' affected fixed interest markets and commercial property values also came under pressure towards the end of the year.

Against this background our with-profits fund earned a return of 5% in 2007, and policies' underlying fair shares have therefore increased. After allowing for tax, smoothing and any policy charges set out in your policy documentation this 5% return will be reflected in policies' values when they mature or are cashed-in in the future.

Q2. How did you set regular bonuses in 2007?

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 aim to set the regular bonus rate so that there is scope in the future for final bonuses if the relevant assets of our with-profits fund provide steady growth. We may set regular bonus rates at a lower level than this when it is necessary to limit losses to the with-profits fund.

This scope for final bonus gives us the freedom to invest in higher-risk assets, such as shares and property, that we expect to give a better but less predictable return over the long term. If we were to set rates of regular bonus at higher levels, we'd restrict our investment freedom and have to invest more of the with-profits fund in more predictable lower-risk assets, such as cash deposits and fixed-interest bonds issued by the government or companies. We would then expect to have less to pay out to policyholders.

We followed this approach in 2007 and were able to increase regular bonuses for most classes of unitised with-profits policy. This did not include With Profits Bonds and conventional policies, though those policy types have still benefitted from the returns earned in 2007. Although not reflected in regular bonuses for those policies, the underlying asset shares increased in 2007. Question 3 explains how final bonus is used to reflect increases in assets shares in final payouts.

Q3. How did you set final bonuses that applied in 2007?

With-profits investing includes a special feature called 'smoothing'. The stockmarket goes up and down daily and can move a lot in a short space of time. We aim to smooth out some of the effects of these short-term peaks and troughs. We have continued to smooth payouts, and as a result maturity payments were less affected by the fluctuations in the stockmarket in 2007.

This smoothing is reflected in the final bonuses that we set. These final bonus rates are set so that policy payouts reflect the underlying fair share of the with-profits fund for each group of policies (based on the underlying asset shares). Final bonuses make up the difference between the benefits that have already been guaranteed (including accumulated regular bonus) and those fair shares (which include adjustments, which could be upwards or downwards, for smoothing).

However, we only aim to smooth the effects of fluctuations over the most recent two year period. So smoothing will not lessen the effects on maturity payouts of policies of longer-term changes in the stockmarket, such as those described in our answer to question 4.

We follow a similar approach when setting payout values for policies that are cashed-in before their normal maturity or retirement dates, though usually with less smoothing being applied.

Over 2007 this overall approach led to increased payout values for most policies.

Q4. Why do the newspapers keep saying maturity payouts are falling?

The newspapers often compare policies that started at different times, so the comparison can be misleading. For example, a 25-year policy maturing in 2008 would have started in 1983. Each premium will have been paid a year later than the same premium for a policy maturing in 2007 (which started in 1982). Investment returns were very high in the 1980s and 1990s, and so for the later policy each premium had one year less in which to gain from those very high returns.

The 1980s were particularly good – the average return on our with-profits fund was more than 20% a year in that decade. The earlier a policy started, the more it will have gained from those returns. And the earlier a policy started, the more premiums will have been paid by the time of the 1990s – a decade in which returns were still strong, with four years seeing returns of more than 15% and only two falling below 10%. So despite the positive returns of the last few years, in many cases a policy maturing in 2007 would have received a better investment return overall than a policy maturing in 2008 of the same term.

Q5. You have referred to investment freedom allowing better future returns. What is your investment policy?

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.

So we have continued to hold a significant part of the fund in higher-risk investments such as company shares and property to try to achieve higher returns. The rest is in lower-risk investments such as fixed-interest bonds issued by the Government or by companies. Details on the mix of assets are given in our answer to question 6 below.

Q6. How much of each investment type do you hold?

The investment types backing most of the with-profits policies are shown below. Overall we held 66% of assets in equity shares and property at the end of 2007. We expect these assets to give better returns over time, though they may fluctuate more in the short term. Smoothing helps to even out those fluctuations. Fixed interest investments are issued by the government or by companies (“corporate bonds”). Corporate bonds offer a higher return, as long as the issuing companies honour their obligations to make payments when due. During 2007 the prices of corporate bonds fell relative to government bonds. We took this opportunity to increase the proportion of corporate bonds as our investment managers judged that their cheaper prices made them attractive to buy. We took full account of the risk that the issuing companies may not honour their obligations in making that decision, and we only buy good quality corporate bonds (known as ‘investment grade’).

	31 Dec 2005	31 Dec 2006	31 Dec 2007
Fixed interest			
● UK government bonds	19%	16%	10%
● Corporate bonds	15%	15%	19%
Property	11%	10%	12%
Equity shares			
● UK shares	41%	43%	44%
● Non-UK shares	10%	8%	10%
Other investments	4%	8%	5%

The percentages that apply to our Flexible Option Bond and Pensionplanner policies can be found on our website.

Q7. What other reassurances do I have that you have followed your Principles and Practices of Financial Management?

There are five main controls in place to ensure this:

- Whenever we make important choices that affect the way we manage our with-profits policies, our With-Profits Actuary, who advises the Board of Scottish Widows plc, presents a report for the directors giving the reasons behind the proposals, and how these comply with the Principles and Practices of Financial Management.
- Our With-Profits Committee¹ reviews advice being given to the Board. The Committee scrutinises this advice so that it can be satisfied that the way we manage our with-profits business is in line with our published Principles and Practices of Financial Management, and with all relevant regulations (including our duty to treat policyholders fairly).
- Throughout the year, all the data, work and actions that supported our decisions have been recorded. The With-Profits Actuary has reviewed this evidence, and is satisfied the decisions were consistent with the Principles and Practices of Financial Management. 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 and the Board covering the areas where decisions were made, and how they complied with the Principles and Practices of Financial Management.
- The With-Profits Committee also received a report from an independent actuary, who reviewed the advice of our With-Profits Actuary. He raised no material concerns.

4. Conclusion

The Board of Scottish Widows plc met on 26 March 2008 to consider all the issues referred to above, the recommendations of the With-Profits Committee and the evidence presented to them by the With-Profits Actuary. The Directors are satisfied that Scottish Widows has managed its with-profits business in line with the Principles and Practices of Financial Management.

The Directors of Scottish Widows plc

31 March 2008

Annex – Statement to With-Profits Policyholders by the With-Profits Actuary of Scottish Widows plc

In my opinion Scottish Widows' management of its with-profits business in 2007, and the report to which this statement is attached, have taken the interests of with-profits policyholders into account in a fair and balanced way. In reaching this opinion I have taken into account the information and explanations provided to me by Scottish Widows plc, and relevant rules and guidance issued by the Financial Services Authority.

Kevin M Doerr

**Fellow of the Institute of Actuaries
With-Profits Actuary (Scottish Widows plc)**

31 March 2008

¹ The With-Profits Committee is a sub-committee of the Board of Scottish Widows plc and is made up of directors not involved in the day-to-day running of the company

