Your guide to with-profits

Important information about investing in our with-profits fund using one of our Group Pensionplanner contracts.

The PPFM will apply where there is any difference between the information in it and the information in this guide.

We have written this guide to give you more information about your scheme being invested in one of our Group Pensionplanner with-profits contracts. Where we say 'you' or 'your' we mean you acting as a trustee of the scheme.

You may know your Group Pensionplanner contract under a different name, for instance, as a Group Pension Bond.

This guide contains information from a longer, more detailed, document called our Principles and Practices of Financial Management ('PPFM'). We have tried to make sure that this guide accurately reflects the PPFM. But the PPFM will apply if there is any difference between the information in it and the information in this guide.

The full PPFM is on our website at www.scottishwidows.co.uk/PPFM, or you can ask us to send you a copy. Our address is given at the end of this guide in the section "How can I get more information?"

We've set out the information in this guide as answers to the following questions.

What is meant by with-profits?

We use the term 'with-profits' to mean a type of investment. In the case of a Group Pensionplanner contract this investment provides guaranteed benefits with the possibility of bonuses.

Your scheme's money is invested in part of our with-profits fund with the money invested by other holders of Pensionplanner contracts.

Each time your scheme invests in your Pensionplanner contract we give you a guarantee that in certain circumstances we would pay out at least a minimum amount of pension. A description of the main guarantees and the circumstances when they apply are given in "What are the guarantees?" on page 4. We may also pay your scheme cash bonuses. Further information on possible bonuses is given in "What types of bonus may be added to my contract?" on page 4.

There are circumstances when the guarantees do not apply to an amount that we pay out (see "What if some (or all) with-profits benefits are given up before their guarantees apply?" on page 6).

Our approach to managing our with-profits fund can change from time to time.

The with-profits fund

The overall with-profits fund invests in a mix of assets such as bonds, company shares, property and cash deposits. Bonds are a type of loan, usually to the Government or companies. The proportion of the with-profits fund that is put into each of these different types of assets will vary over time. The mix of the part relevant to Pensionplanner contracts is different from that of the other parts of the with-profits fund. For information on the mix for Pensionplanner contracts, see "*Investment performance*" on page 6.

We may also use 'derivatives', which are specialist forms of investments. We apply strict controls over our use of derivatives and use them to reduce investment risk. For example, some derivatives give the with-profits fund the right to buy or sell assets at a fixed price at a future date.

Your group

When managing the with-profits fund we often look separately at different groups of contracts. Pensionplanner contracts form two such groups.   One of the groups relates to the parts of the contracts that relate to members of schemes who joined before Scottish Widows demutualised on 3 March 2000. The second group relates to those members who joined after then.

Our shareholders

Scottish Widows plc is a ‘proprietary company’. This means that we have shareholders. Our shareholders receive the charges that we make on contracts like yours and in return meet the cost of looking after your contract. They also get a payment each year of up to one ninth of the value of the bonuses that we add to contracts like yours. However this payment comes from a part of the with-profits fund specifically set up, when Scottish Widows demutualised in March 2000, to cover it. The payment does not affect what your scheme gets back from your contract.

What are the guarantees?

Your contract provides guarantees. When your scheme pays a contribution to the contract we give you a guarantee of an amount of pension. This pension is the minimum that the contract will contribute towards the benefits for one or more particular members of the scheme. We usually allocate contributions first to those members who are closest to retirement. The guarantee applies if the member takes retirement benefits on his or her normal retiring date.

Some Pensionplanner contracts, for an additional cost, also guarantee the amount of a cash alternative to all or part of the guaranteed pension.

The guarantees also influence what we pay when an individual member takes pension at some other time or transfers to another scheme. They do not apply if you decide to surrender all or part of your contract (see “What if some (or all) with-profits benefits are given up before their guarantees apply?” on page 6).

What types of bonus may be added to my contract?

Final bonus, sometimes called ‘terminal bonus’, may be paid when a member of your scheme takes retirement benefits. Any final bonus is paid as a cash sum, which helps the funding of your pension scheme.

We decide rates of final bonus twice a year, but we could change them at other times. Future rates of bonus are not guaranteed.

Until 2000 we also paid regular bonus. At present the level of the guarantees under Pensionplanner contracts is such that we do not expect to pay any further regular bonuses, and we expect final bonuses to be generally limited to small amounts resulting from the demutualisation.

How do you decide final bonuses?

Final bonus

There are separate rates of final bonus in respect of members of the schemes invested in Pensionplanner contracts who became members in different years. To set these rates we take notional members who are approaching their normal retiring date. We take a notional member for each year of entry. We assume a representative pattern of the purchase of their benefits over the period of membership from the year of entry until the guarantee date. Because any final bonuses are in cash sums and go to the retirement benefits scheme rather than to the member, the emphasis is on fairness to the schemes.

We then follow the procedure below.

We set a 'target payout level' for each notional member. To help us to work out the target levels we:

- take the 'asset share' of the notional members (see *"Asset shares"* on page 6);
- increase it so that it includes the investment returns we expect to earn between when we set the final bonus and when the pensions are due to start; and
- make the adjustment for the smoothing of recent investment returns described below, which gives us a 'smoothed asset share'.

We then compare each target level with the value of the corresponding guaranteed pension and pay a final bonus if the target level is bigger. In other words, we aim to 'top up' what schemes get from the guaranteed benefits if and when this is necessary to reflect the value of the target pension levels for the notional members.

An increase in the average time we expect people to live increases the value of guaranteed pensions and hence reduces the likelihood or amount of a final bonus.

There is a final stage which adds a small amount to the results of the above process. This results from our demutualisation and is, currently, up to around 2% of the value of the total payout. It applies in the case of most members of schemes, but does not apply in the case of members who joined schemes after the demutualisation.

Overall, we aim that total payouts over many years are at least equal to the asset shares plus any additions from the above final stage.

Smoothing

When working out the above target levels we make an adjustment 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 don't consider movements outside the last two years. So smoothing will not lessen the effects on your return of longer-term changes in the stockmarket. Smoothing is complex and more details of our approach are in our PPFM.

What if a member dies before starting his or her pension?

The with-profits guarantees don't apply if a member dies before starting his or her pension. If this happens, any amount that your contract will pay back to your scheme will depend on the terms of your Pensionplanner contract.

We will pay out an additional benefit if your scheme has been paying for separate, non-profit death benefits under your contract. We don't cover details of this in this guide.

What if some (or all) with-profits benefits are given up before their guarantees apply?

Our aim is to maintain a fair level of payouts to all schemes investing in Pensionplanner contracts.

When the transfer covers a number of members of a retirement benefits scheme, we normally target 95% of asset shares (see below) for a transfer value to another scheme or investment. We may add a further small amount. This results from our demutualisation and is, currently, up to around 2% of the total payout. For such transfer values we allow for market movements up to the date of the transfer.

When a transfer value is payable in respect of one or only a few members, we usually value the deferred pensions being given up. We do this by considering what you would currently have to pay if instead you were buying these pensions, in line with the terms of your contract. The final bonus (if any) that we add is at the rates that apply to members who entered at the same time and are reaching retirement, reduced to reflect how long it would have been before the deferred pensions were due to start.

Relatively minor adjustments take place when a member retires with more pension having been bought under a contract than is needed to cover the member's entitlement to benefits under your scheme's rules. The value of the excess pension is worked out using a similar approach to that described in the paragraph above. It is normally re-applied to buy benefit in respect of another member.

What affects bonuses?

Asset shares

To see what scope there is for paying bonuses, we track what we call 'asset shares' of the with-profits fund. We track them for the notional members for each year of entry.

Asset shares help us decide the bonuses to pay and the fair payments when guarantees don't apply. The way this works is described earlier in this guide.

Very broadly, asset shares are an accumulation of the amounts invested. So when deciding what an asset share would be, we look at the following three main factors:

- the representative amounts assumed to have been invested in respect of those notional members;
- when they were assumed to be invested; and
- the past investment performance of the ‘relevant assets’ (see “*Investment performance*” below).

We also make adjustments for:

- the charges we have made to cover the cost of managing contracts;
- taxation;
- a regular ‘capital fee’ (a 0.3% a year deduction from the asset share); and
- any profits and losses from ‘business risks’ that affect asset shares (see below).

The capital fees are added to a special account kept separate in the with-profits fund called the ‘Additional Account’. Some profits and losses from business risks don’t affect asset shares for your type of contract. Instead, they are added to or taken from the Additional Account. More information on business risks and the Additional Account is given in “What are the risks of investing in a Pensionplanner contract?” on page 8.

Investment performance

This guide sometimes refers to ‘relevant assets’. These make up the part of the with-profits fund whose investment performance could have an important effect on what your scheme will get back. The performance will depend on, among other things, how much of the relevant assets are made up of each of the different types of asset.

We hold a small part of the relevant assets for Pensionplanner contracts in higher-risk assets such as shares, to try to achieve a degree of higher-returns. However, because of the size of the guarantees under Pensionplanner contracts, a high proportion is in lower-risk assets, such as fixed-interest bonds issued by the Government or by companies.

The performance of different types of asset varies over time. So we may change the mix of the assets with the aims of:

- making sure that the with-profits fund can always meet its guarantees; and
- subject to that aim, getting the best possible long-term performance.

When doing so we allow for support from some of our assets outside the with-profits fund, following guidelines set at the time of the demutualisation. This means that we can invest some of the relevant assets in shares and property. (See also “What is the capital support for the with-profits fund?” on page 9.)

We include information about the mix of assets in the PPFM section of our website. You’ll therefore be able to see how we review and change the mix of the assets over time.

What are the risks of investing in a Pensionplanner contract?

The main potential risk of any investment of the assets of a defined-benefits pension scheme is the extent to which they will or will not yield enough to meet the scheme's liabilities. High inflation can heighten this risk for many schemes. The investment mix that we describe under "*Investment performance*" above, and the other characteristics of Pensionplanner contracts, will be more suitable for some pension schemes than for others. This is not a matter that we can cover in a general guide such as this. Rather, it is a subject for discussion with your Scheme Actuary.

There are other risks, known as 'business risks', from investing in a Pensionplanner contract. These risks do not affect the guarantees that we have given, but they do affect the prospects for future bonuses. They also affect the amount that would be available for transfer to another scheme or investment.

Two business risks may affect the asset shares for Pensionplanner contracts.

- Profits or losses arising when members die who have had deferred pension benefits bought for them but have not yet retired. These profits or losses are differences between the with-profits benefits paid and the value of the pension that had been bought.
- Profits or losses resulting from pensioners living for a shorter or longer time than was expected when they retired.

Profits or losses arising from other business risks would normally not affect the asset shares for contracts like yours. Instead they would be paid into or taken from a separate part of the with-profits fund known as the Additional Account. This Additional Account was set up when we demutualised to cover such things. Anything left over in it would be paid out as extra final bonus to the remaining contracts that were started on or before 3 March 2000, including your contract to the extent that it relates to members who had joined your scheme by that date. If the Additional Account is not sufficient to cover losses arising from business risk, any later losses would be met firstly from assets outside the with-profits fund. However in extreme cases some losses could be shared among all the with-profits contracts that were started before we demutualised.

The main business risks to the Additional Account come from the guarantees and smoothing of the payments that we make to you and other with-profits investors, particularly Pensionplanner investors. When we apply smoothing and guarantees we increase what we pay some contracts. This leaves less in the with-profits fund for the other contracts. On the other hand, when we pay some contracts less because of smoothing it leaves more for the other contracts.

The Additional Account is also exposed to smaller business risks, including the following:

- the with-profits fund's profits and losses from the non-profit policies that were transferred into it in March 2000, when we demutualised; and
- the cost of compensation paid to the holders of policies sold by Scottish Widows before demutualisation, if any are shown to have been mis-sold.

There are naturally risks associated with your contract that apply to other sorts of investment and not just to with-profits contracts. Those other risks, such as the risk that the taxation of