

PRINCIPLES & PRACTICES OF FINANCIAL MANAGEMENT OF WITH PROFITS BUSINESS

Effective 1 April 2009

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1. INTRODUCTION

- 1.1 The document has been prepared in accordance with the requirements of COBS 20.3 of FSA's Conduct of Business Sourcebook and details the Principles & Practices of Financial Management (PPFM) of With Profits business currently adopted by Scottish Equitable plc.
- 1.2 The purpose of the document is to help further the understanding of current and potential with profits investors as to the way in which Scottish Equitable plc (the "**Firm**") manages its with profits business and provide details on the governance procedures for such business.
- 1.3 If any changes are proposed to the Principles, with profits policyholders will be notified in writing three months in advance of the effective date of the proposed changes. If any changes are made to the Practices, policyholders will be notified within 12 months of the effective date of change.
- 1.4 An annual report will be produced by the **Firm** confirming whether, throughout the financial year to which the report relates, the **Firm** believes it has complied with the PPFM and setting out the reasons for that belief.
- 1.5 Annexed to the report detailed in 1.4 will be a statement from the **Firm's With Profits Actuary** as to whether, in his opinion and based on the information and explanations provided to him by the **Firm**, the report detailed in 1.4 and the discretion exercised by the **Firm** over the period in question have taken into account the interests of with profits policyholders in a reasonable and proportionate manner.
- 1.6 In accordance with the **Firm's** governance arrangements, Scottish Equitable Policyholders Trust Limited has agreed to provide an element of independent judgement in the ongoing assessment of compliance with the PPFM.
- 1.7 Further information can be obtained from AEGON Scottish Equitable, Edinburgh Park, Edinburgh, EH12 9SE.
- 1.8 Explanations of words and phrases highlighted in bold are given in the Glossary at the end of the document.

2. VARIATION PROVISION

- 2.1 The Directors believe that the Principles should not, normally, vary in the short term as they set out the general approach to the management of with profits business. The Practices cover more detailed points and may vary more frequently. Notification of any variations to Principles or Practices will be given in accordance with requirements applicable from time to time.
- 2.2 Notwithstanding the foregoing :
- 2.2.1 The Directors expressly reserve the right to vary the Principles and Practices at any time if appropriate in order to achieve any of the following - to maintain the financial solvency of the Fund, to meet legal or regulatory requirements as identified or applied from time to time or otherwise to maintain equity amongst different categories or generations of with profits policyholders in the changed circumstances that may prevail from time to time.
- 2.2.2 The Directors are obliged at all times to manage the with profits business of the **Firm** in accordance with the **Scheme** approved by the Court of Session that authorised and gave effect to the transfer of business from Scottish Equitable Life Assurance Society to the **Firm** with effect from 31 December 1993.
- 2.2.3 The Directors are obliged to give effect to legal and regulatory requirements as they apply to the **Firm** in a way that meets those requirements.

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3. PRINCIPLES OF FINANCIAL MANAGEMENT OF WITH PROFITS BUSINESS FUNDS WITH INVESTMENT GUARANTEES

3.1 General

- 3.1.1 At 31 December 1993, the assets and liabilities of Scottish Equitable Life Assurance Society were transferred to the **Firm** under a Scheme of Transfer pursuant to Section 49 of the Insurance Companies Act 1982 (“the **Scheme**”).
- 3.1.2 As a result of the Scheme, the **long-term insurance fund** of the **Firm** was notionally divided into a **With Profits Subfund (WPSF)** and a **Non Profit Subfund (NPSF)**. The purpose of establishing the **WPSF** and **NPSF** is for internal accounting purposes only (with a view to establishing respective policyholder entitlements from time to time) and is not intended to denote any separation of ownership. Additionally, a **shareholder’s** fund was created, whose assets do not form part of the **long-term insurance fund**.
- 3.1.3 The **WPSF** contains all with profits business that was in-force as at 31 December 1993. Subsequent new with profits business (excluding single premiums and increments under in-force **traditional with profits** policies) has been written in the **NPSF** with the **investment element** of such business being transferred to the **WPSF**. With profits policyholders participate in the investment profits/losses arising in the **WPSF** as well as any profits/losses that arise on non profit business in the **WPSF** (e.g. certain annuities), as stipulated in the **Scheme**.
- 3.1.4 The **shareholder** has no financial interest in the **WPSF** beyond an annual management charge that is taken from the assets backing **unitised with profits** policies and an agreed level of annual expense (as provided for in the **Scheme**) from the assets backing traditional (non-unitised) policies.
- 3.1.5 The **Scheme** establishes the principles governing the management of with profits business within the **WPSF**.
- 3.1.6 Within the **WPSF**, a number of individual with profits funds have been notionally created with specific characteristics. These are typically related to the levels of guarantee on offer (and consequently the asset mix of the fund) and whether the business is life or pensions.
- 3.1.7 The **Firm** no longer writes new with profits business with investment guarantees that may attract **annual and final bonus** additions, apart from, potentially, increments, renewal premiums and single premiums under policies in-force as at 30 September 2002 and new entrants to occupational pension schemes that were in force as at 30 September 2002. Consequently, the in-force block of such business is now in decline.
- 3.1.8 “**Firm**” in this document refers to Scottish Equitable plc.
- 3.1.9 No with profits business with investment guarantees is written as **stakeholder** business.

3.2 The Amount Payable under a With Profits Policy

- 3.2.1 Amounts payable under with profits policies are guided by the calculation of “**asset shares**” (see 4.2), as indicated in the **Scheme**.
- 3.2.2 At the point of demutualisation on 31 December 1993, AEGON nv (the **shareholder**) made a **capital contribution** of £208m to the **WPSF**. This contribution was for the

benefit of with profits policyholders and £160m of it has been used to enhance **asset shares** in accordance with the **Scheme**. The **shareholder** has also made subsequent **capital contributions** to the **WPSF** that are also for the benefit of with profits policyholders. These contributions may be used to enhance **asset shares** in future but there is no requirement to do so under the **Scheme**.

- 3.2.3 To the extent considered appropriate, the investment returns that underpin the calculation of **asset shares** are adjusted to make some allowance for the expected costs of guarantees and costs for the use of capital.
- 3.2.4 Consistent with the concepts of pooling and smoothing, bonus rates are not set by reference to individual policy **asset shares**, rather by reference to the **asset shares** of groups of individual policies with similar characteristics (e.g. by in-force duration to the last whole year).
- 3.2.5 The methods used to set payouts to policyholders aim to ensure that payouts represent fair value in relation to the investment returns achieved and the risks borne by the **WPSF**.
- 3.2.6 Any changes to the methods used to set payouts require the approval of the Board.
- 3.2.7 No changes would normally be made to any historic assumptions or parameters underpinning the calculation of **asset shares**, unless an error in such assumptions or parameters was subsequently discovered. However, future changes may be appropriate on account of, for example, developments in actuarial techniques, enhanced systems capabilities or legal judgements or to take into consideration tax assessments when finalised.
- 3.2.8 The Practices contain details of the approximations underpinning the calculation of the amounts payable to with profits policyholders. Examples of such approximations would be the application of monthly (rather than daily) investment returns in the calculation of **asset shares** and the grouping together of policies with similar characteristics in determining affordable **annual bonuses, final bonuses & market value reductions**. Any approximations are applied consistently and are intended to have a broadly neutral effect over time and within product type.

3.3 Overriding Principle

- 3.3.1 The overriding principle that the **Firm** seeks to apply (subject to regulatory and legal requirements as interpreted and established from time to time) in determining **annual & final bonus** rates and **market value reductions (MVRs)** is to maintain equity between different classes and durations of policyholders (“the Overriding Principle”). Bonus declarations are made at the absolute discretion of the Board.
- 3.3.2 When determining **annual & final bonus** rates and **MVRs** from time to time in accordance with the Overriding Principle, the **Firm** shall have regard to **asset shares** and **smoothed asset shares** (see 3.5.1) and the other matters and provisions described in these Principles and in the Practices annexed. The concepts of **Asset Share** and **Smoothed Asset Share** do not, however, represent policyholder entitlement but are a guide to meeting the objective that bonus declarations, from time to time, accord with the Overriding Principle.
- 3.3.3 In approaching the question of bonus declarations, it is considered significant that policyholders are entitled to 100% of profits or losses emerging in the **WPSF** and no part accrues for the benefit of **shareholders** in the **Firm**. Accordingly, the scope for any conflict of interest between **shareholder** and policyholder in determining bonus policy is thereby reduced.

3.4 The Approach to Setting Annual Bonus Rates

- 3.4.1 The general aim in setting **annual bonus** rates is for, at the point a claim arises, less than 100% of **asset shares** to be targeted as coming from a combination of **guaranteed benefits** and **annual bonus** additions. The higher the proportion of the backing assets invested in equities, the lower this target percentage and *vice versa*. For some contracts, this target percentage may be 100%.
- 3.4.2 Different rates of **annual bonus** apply depending on the characteristics of individual products or funds (e.g. guaranteed growth rates, investment mix, tax).
- 3.4.3 Within a specific fund or contract, the same rate of **annual bonus** typically applies to all policies, irrespective of when investments were made. This could change if the **asset shares** of particular **cohorts of policyholders** were low relative to their **guaranteed benefits**. In such a circumstance, it could be appropriate for lower **annual bonus** rates to apply to that cohort.

3.5 The Approach to Setting Final Bonus Rates and/or Market Value Reductions (MVRs)

- 3.5.1 **Asset shares** are calculated for groups of policies with similar durations, except that investment returns are normally smoothed. This results in "**smoothed asset shares**".
- 3.5.2 **Final bonuses** are then normally declared or applied having regard to any excess, for groups of policies, of 100% of **smoothed asset shares** above **guaranteed benefits** (including **annual bonus** additions). This principle applies to all claim types, including surrenders.

MVRs are then normally applied having regard to any shortfall, for groups of policies, of 100% of **smoothed asset shares** below corresponding unit values (including **annual bonus** additions). This principle only applies to claim types under which an MVR may be applied (e.g. surrenders).

- 3.5.3 The different rates of **final bonus** applying will be determined at the discretion of the **Firm** having regard to the characteristics of individual products or funds (e.g. guaranteed growth rates, investment mix, tax).
- 3.5.4 It will not always be appropriate to set **final bonus** rates that target 100% of **smoothed asset share** on claim. For example, if the volume of in-force with profits business reduces, the degree of smoothing may need to change if the remaining policyholders are to obtain fair values at the point of claim.
- 3.5.5 It may be appropriate to pay less than 100% of **smoothed asset share** on claims if, otherwise, the interests of the remaining policyholders could be unduly adversely affected. This situation could arise if, for example, a group of policyholders sought to withdraw at a time when significant upward smoothing was taking place.
- 3.5.6 It would not be appropriate to pay 100% of **smoothed asset share** on claims if this could jeopardise the solvency of the **Firm** or would be contrary to the Overriding Principle.

3.6 The Approach to Smoothing

- 3.6.1 No significantly different approach to smoothing would normally be made by type of claim.

- 3.6.2 The **Firm's** intention is that the cost of smoothing should be neutral over time. This means that, at different times, payouts to policyholders may be guided by more or less than 100% of **unsmoothed asset shares**.
- 3.6.3 There are specific costs of smoothing over the shorter term that the **Firm** believes should not be exceeded.
- 3.6.4 The calculation of **MVRs** for unitised business and surrender values for traditional (non-unitised) business is normally only made by reference to underlying asset values. However, there may be occasions where policyholder behaviour has an impact; for example, if a group of policyholders sought to withdraw at a time when significant upward smoothing was taking place.

3.7 Investment Strategy

- 3.7.1 The investment strategy under an individual with profits fund (see 3.1.6) is linked to the associated level of guarantee (including **annual bonus** additions to date). The assets backing funds with high guarantees typically invest heavily in fixed interest securities of an appropriate duration. In funds that have lower levels of guarantee, the **Firm** would normally aim to invest more in equities.
- 3.7.2 In certain circumstances the **Firm** may rely on assets held within the **NPSF** or **shareholder's** fund in order to maintain the investment strategy in the **WPSF**. This is consistent with the measurement of solvency at a global level rather than at **WPSF** level.
- 3.7.3 It may be appropriate to utilise **derivatives** to protect the **WPSF** against adverse market movements (e.g. equity falls or changes in fixed interest yields). It may also be appropriate to utilise **derivatives** for short-term asset allocation purposes or to increase diversification by gaining exposure to different asset classes or for efficient portfolio management.
- 3.7.4 Exposures to individual **counterparties** (including **derivative** exposures) across the entire **Firm** would not normally exceed **regulatory admissibility limits**. An appropriate spread of assets between **counterparties** will be held in order to reduce risk.
- 3.7.5 The **WPSF** would not usually expect to invest in assets that would not normally be traded because of their importance to the **Firm**.

3.8 Business Risk

- 3.8.1 The **WPSF** is not exposed to any of the business risks associated with the writing of new policies. All such risks are borne by the **NPSF**. Under the **Scheme**, certain liabilities emerging in respect of business undertaken prior to 1 January 1994 will be met by the **WPSF**. This mainly relates to liabilities which may arise from or in connection with the conduct of business by Scottish Equitable Life Assurance Society prior to its demutualisation as set out more fully in the Scheme.
- 3.8.2 The **Firm** no longer writes new with profits business with investment guarantees. The capital required to cover **regulatory solvency requirements** on new with profits business (without investment guarantees) is held in the **NPSF**.

3.9 Management & Administration Expenses

- 3.9.1 All expenses are met from the **NPSF**.

3.9.2 On traditional (non-unitised) policies, the **WPSF** pays an agreed level of expenses to the **NPSF** in accordance with the **Scheme**.

3.9.3 On unitised policies, the **WPSF** pays an annual management charge to the **NPSF**. In accordance with policy conditions and the **Scheme**, the level of charge is equal to that taken from equivalent unit-linked funds. Apart from on certain business lines, charges can be reviewed from time to time.

3.10 Management of the Inherited Estate

3.10.1 The **Firm** aims to distribute any **WPSF inherited estate** equitably to with profits policyholders (excluding those funds that offer no investment guarantees) in accordance with the Overriding Principle.

3.10.2 The **Firm** aims to maintain a sufficient level of **estate** within the **WPSF** to meet the regulatory requirements that would apply were the **WPSF** a separate **firm**.

3.10.3 The **shareholder** has no entitlement to any **WPSF inherited estate**.

3.10.4 The **inherited estate** provides capital support towards meeting **regulatory solvency requirements**.

3.10.5 The **inherited estate** may be used to meet the costs of certain guarantees.

3.11 Volumes of New Business and Arrangements on stopping taking New Business

3.11.1 No new with profits business with investment guarantees is written in the **WPSF**, apart from, potentially, increments, renewal premiums and single premiums under policies in-force as at 30 September 2002 and new entrants to occupational pension schemes that were in force as at 30 September 2002 (see 3.8.2).

3.11.2 The volume of increment, renewal and single premium business plus new occupational scheme entrants investing in with profits funds with guarantees is kept under review.

3.12 Equity between the With Profits Fund and the Shareholder

3.12.1 In accordance with the **Scheme**, all investment profits (and losses) on assets notionally allocated to the **WPSF** are held for the benefit of with profits policyholders.

3.12.2 With profits policyholders have no entitlement to profits (or losses) that arise from assets notionally allocated to or business conducted in the **NPSF**, which accrue for the benefit of the **shareholder**. However, assets in the **NPSF** and **shareholder's** fund are available to support **WPSF** solvency should there be insufficient assets within the **WPSF** to meet its liabilities and vice versa.

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4. PRACTICES OF FINANCIAL MANAGEMENT OF WITH PROFITS BUSINESS FUNDS WITH INVESTMENT GUARANTEES

4.1 General

- 4.1.1 The **Firm** has written a variety of with profits business over many years. In particular, there is a wide range of funds with differing levels of guarantee in existence.
- 4.1.2 The **Firm** writes no new with profits business with investment guarantees, apart from, potentially, increments, renewal premiums and single premiums under policies in-force as at 30 September 2002 and new entrants to occupational pension schemes that were in force as at 30 September 2002.
- 4.1.3 Within the **WPSF**, assets are notionally allocated to with profits funds with particular characteristics as follows. Any references to guarantees are in the context of the specific points in time where guarantees may apply (e.g. maturity, death, retirement at selected retirement date, regular income withdrawals, withdrawals at a specific anniversary).

4.1.3.1 Traditional With Profits (TWP) / Unitised With Profits (WPE, WPC & WWP)

This includes all traditional (non-unitised) with profits business whether life or pensions. It also includes **unitised with profits** (WPE, WPC & WWP) business.

The WPE fund was first made available under unitised pension contracts during 1984 and was completely closed to all future premiums on 31 October 1999. All **unitised with profits** life business under policies sold in connection with mortgages was written in the WPC fund. A small volume of reinsured business from Royal Scottish Assurance plc is also written into the WPC fund. **Unitised with profits** business written under the **Firm's** Passport for Life contract is linked to the WWP fund.

Guarantees on offer at outset under **TWP** contracts were typically in the range 2% p.a. – 5.5% p.a.

Guarantees under the WPE, WPC & WWP funds (which also apply to **annual bonus** additions to date) are around 5.5% p.a., 3.9% p.a. & 2.7% p.a. respectively.

4.1.3.2 Unitised With Profits (WP1)

The WP1 fund was available under new unitised pension contracts from 1 January 1996 to 31 October 1999, at which point it was closed to all future premiums.

The WP1 fund offers a guaranteed rate of return of 4% p.a. in the unit value (which also applies to **annual bonus** additions to date).

4.1.3.3 Unitised With Profits (WP2)

The WP2 fund was available under new unitised pension contracts from 1 February 1996 to 30 September 2002, at which point it was closed to new business.

The WP2 fund offers a guaranteed rate of return of 0% p.a. in the unit value (i.e. guaranteed return of capital including **annual bonus** additions to date).

4.1.3.4 Unitised With Profits (DAF)

The DAF fund was available under new unitised pension contracts from 3 June 1996 to 30 September 2002, at which point it was closed to new business.

The DAF fund offers a guaranteed rate of return of 0% p.a. in the unit value (i.e. guaranteed return of capital including **annual bonus** additions to date).

4.1.3.5 Unitised With Profits (DA2)

The DA2 fund was available under new unitised pension contracts from 1 September 1999 to 30 September 2002, at which point it was closed to new business.

The DA2 fund offers a guaranteed rate of return of 3% p.a. in the unit value (which also applies to **annual bonus** additions to date).

4.1.3.6 Unitised With Profits (WPB)

The WPB fund was available under new with profits bond contracts from 1 November 1996 to 30 September 2002, at which point it was closed to new business.

The WPB fund offers a guaranteed rate of return of 0% p.a. in the unit value (i.e. guaranteed return of capital including **annual bonus** additions to date).

4.1.3.7 Unitised With Profits - Deposit Administration (Reflex DA)

The Reflex DA fund is available under the **Firm's** Reflex contracts and offers a guaranteed rate of return of 5% p.a. in the unit value (which also applies to **annual bonus** additions to date). This contract was closed to new business in 1984.

4.1.3.8 Unitised With Profits – Deposit Administration (Others)

Other deposit administration contracts are SE Funding (SEF), Barclays Retirement Accumulator Plan (BRAP), Money Plus and Money Purchase Plan, which guarantee a return of capital including **annual bonus** additions to date. These contracts were all closed to new business by February 1987.

4.1.4 The asset mixes of each of the **notional subfunds** in 4.1.3 are different. In general, the higher the rate of guarantee, the greater proportion of the backing assets is likely to be invested in fixed interest securities.

4.1.5 **Guaranteed Annuity Options (GAOs)** exist under a number of pension contracts, as do **GMP** guarantees under certain Individual Buyout contracts, the costs of which are met from the **WPSF**.

4.1.6 One of the principles underpinning the **Scheme** (see 3.1.1) is that each of the **WPSF & NPSF** (while, essentially, both parts of a single **long-term insurance fund**) should be self sufficient in capital terms. Reference is made in 3.2.2 to the substantial **capital contributions** paid by AEGON nv to the **WPSF**. It is not anticipated that any further support will be necessary.

4.2 The Amount Payable under a With Profits Policy

- 4.2.1 The amounts payable to policyholders are guided by the calculation of **asset shares**, which would normally be calculated on a monthly basis but no less frequently than annually.
- 4.2.2 For **unitised with profits** policies, **asset shares** reflect the accumulation of premiums applied plus **capital contribution** enhancements (where appropriate) plus distributions from the **estate** less **contract charges** less contributions towards the expected costs of guarantees less investment expenses less costs for the use of capital less any partial withdrawals made by the policyholder, at the rate of investment return on the underlying assets notionally backing the relevant policies, adjusted for tax where appropriate.
- 4.2.3 For **traditional (non-unitised) with profits** policies, **asset shares** reflect the accumulation of premiums applied plus **capital contribution** enhancements (where appropriate) plus distributions from the **estate** less expenses less contributions towards the expected costs of guarantees less costs for the use of capital at the rate of investment return on the underlying assets notionally backing the relevant policies, adjusted for tax where appropriate. In this calculation, non-investment related expenses are fixed in accordance with the approach detailed within the **Scheme**. Investment related expenses are calculated in a manner that the **Firm** deems reasonably appropriate in accordance with the approach set out in the **Scheme**.
- 4.2.4 The key parameters underpinning the calculation of **asset shares** are -

4.2.4.1 Investment Returns

The investment returns underpinning the **asset share** calculations vary by **notional subfund** (see 4.1.3). The same return is applied to all investments within each **notional subfund** as described in section 4.1.3.

4.2.4.2 Taxation

Investment returns are adjusted for taxation where appropriate, based on estimates of the rate of taxation actually paid by the **Firm** over the appropriate periods.

4.2.4.3 Expense Deductions (TWP Policies)

The approach to expenses is detailed within the **Scheme** (see section 4.9.1).

4.2.4.4 Annual Management Charge (Unitised Policies)

This charge is consistent with that taken from unit-linked funds and is fixed contractually between the policyholder and the **Firm** (generally with powers for the **Firm** to increase that charge thereafter).

4.2.4.5 Capital Contribution Enhancements

At the point of demutualisation on 31 December 1993, the **shareholder** made a **capital contribution** of £160m to the **WPSF** that has been used to enhance **asset shares** (see 3.2.2).

4.2.4.6 Costs of Guarantees

Details on costs of guarantees are given in section 4.5.1.

4.2.4.7 Costs for the Use of Capital

Details on costs for the use of capital are given in section 4.5.2.

4.2.4.8 Distributions from the Estate

Details on **estate** distribution are given in section 4.10.

- 4.2.5 The determination of amounts payable to with profits policyholders in respect of guaranteed or contractual benefits or by way of bonus declarations (which are at the absolute discretion of the Board having regard to the surplus available for distribution and in accordance with the Overriding Principle) have regard to methods of assessment approved by the Board. Records of the parameters and assumptions used are retained by the **Firm's With Profits Actuary**.
- 4.2.6 Any change to the methods used to assist in the determination of the amounts payable to with profits policyholders requires the approval of the Board (and in accordance with the Overriding Principle), as do changes to the current parameters or assumptions (apart from the routine incorporation of new investment returns).

4.3 The Approach to Setting Annual Bonus Rates

- 4.3.1 Different rates of **annual bonus** apply to individual **notional subfunds** (see 4.1.3). Furthermore, within the **TWP** subfund, different rates of **annual bonus** apply to life, pensions regular premium and pensions single premium business.
- 4.3.2 The approach to setting **annual bonus** rates takes account of :
- 4.3.2.1 The relationship between **asset shares** and accrued **guaranteed benefits** at the date at which affordable bonus rates are calculated.
- 4.3.2.2 The expected future rate of return on and the volatility of the assets backing each individual subfund and the consequent level of projected **asset shares** relative to **guaranteed benefits**.
- 4.3.2.3 The impact of the **annual bonus** declaration on the **Firm's** level of **excess regulatory capital**, consistent with 4.3.2.1 & 4.3.2.2.

Exceptions to this approach arise under SEF, BRAP, Money Plus and Money Purchase Plan, where **annual bonus** rates are related to the rate of return on the **WPSF's** fixed interest investments in the previous calendar year, less 0.5%.

- 4.3.3 While the same rate of **annual bonus** currently applies to all policies within an individual subfund, irrespective of when investments were made, it may be appropriate in future to have more than one rate of **annual bonus** within an individual subfund that varies by in-force and outstanding duration.

Exceptions to this approach already exist under the Deposit Administration (Others) subfund, where different rates of **annual bonus** apply to the SEF, BRAP, Money Plus and Money Purchase Plan contracts and also within the contracts themselves, depending on whether or not the contract in question is premium paying or paid-up or if benefits secured relate to initial premiums or otherwise.

- 4.3.4 Under current practice, **annual bonus** rates on contracts investing in the following subfunds are declared in arrears, normally once a year on 31 December :

TWP, WPE, WPC, WWP, WP1 and Deposit Administration (Reflex contracts)

Interim bonus rates for the same contracts are normally declared twice year on 1 April and 31 December respectively. The 1 April declaration applies to appropriate claims in the period 1 April to 31 December and the 31 December declaration applies to appropriate claims in the period 1 January to 31 March.

- 4.3.5 Under current practice, **annual bonus** rates on contracts investing in the following subfunds are declared in advance, normally once a year on 1 April :

WP2, DAF, DA2, WPB and Deposit Administration (Others)

Unit prices of these funds change normally each business day on a basis consistent with the pre-declared rates of **annual bonus**.

- 4.3.6 There are no restrictions on the amount by which **annual bonus** rates may change from one declaration to the next.

4.4 The Approach to Setting Final Bonus Rates and/or Market Value Reductions (MVRs)

- 4.4.1 Different rates of **final bonus** and **MVR** apply to individual **notional subfunds** (see 4.1.3). Furthermore, within the **TWP** subfund, different rates of **final bonus** apply to life, pensions regular premium and pensions single premium business. No concept of **MVRs** exists under **TWP** policies, although the surrender value basis for such policies can vary (see 4.4.9.2).

Within each **unitised with profits** subfund, rates of **final bonus** and **MVR** vary depending on the year and month in which an investment is made. Within the **TWP** subfund, rates of final bonus vary depending on the in-force duration expressed in whole years.

- 4.4.2 The starting point is to calculate **asset shares** as described in Section 4.2 except that investment returns are normally smoothed, resulting in "**smoothed asset shares**". The smoothing process is described in section 4.6.

- 4.4.3 **Final bonuses** are then normally declared or applied having regard to any excess, for groups of policies, of 100% of **smoothed asset shares** above **guaranteed benefits** (including **annual bonus** additions). This applies to all claim types, including surrenders.

MVRs are then normally applied having regard to any shortfall, for groups of policies, of 100% of **smoothed asset shares** below corresponding unit values (including **annual bonus** additions). This only applies to claim types under which an **MVR** may be applied (e.g. surrenders). Under certain policy variants, an additional calculation takes place to ensure that **MVRs** so calculated do not exceed a level indicated by comparing the total unit value within a **notional subfund** with the corresponding expected total associated asset value.

In practice, within each **unitised with profits** subfund some additional second-order rounding of affordable **final bonus** rates and/or **MVRs** also takes place that aims to be cost-neutral. The same applies to **traditional with profits** business, except that

final bonus rates may be smoothed further, typically over a 5-year period. For example, the **final bonus** rate applicable under a **traditional with profits** investment that has been in-force for 20 years is the average of the **final bonus** rates that would otherwise be calculated in respect of policies that have been in force for 18, 19, 20, 21 & 22 years respectively. Additionally, we would not normally allow **final bonus** rates under **traditional with profits** investments to increase by more than 15% or decrease by more than 5% from one quarterly rate review to the next (see 4.4.7).

4.4.4 The cost of smoothing is expected to be neutral over the long-term. However, under certain scenarios a **smoothing account** (see 4.6.2) may become more positive or negative than expected. In such circumstances payouts would not be guided by 100% of **smoothed asset shares**, in order that the **smoothing account** could be returned to a position consistent with its long-term cost-neutral aim.

4.4.5 The normal circumstances in which payouts would not be guided by 100% of **smoothed asset shares**, excluding circumstances when **guaranteed benefits** exceed **smoothed asset shares**, would be when the ratio of the **smoothing account** (see 4.6.2) to the sum of **unsmoothed asset shares** fell outwith the range -0.5% to 0.5%, in accordance with the following :

- If the ratio of the **smoothing account** to the sum of **unsmoothed asset shares** is less than -2%, payouts currently equal 90% of the minimum of **unsmoothed asset share & smoothed asset share**.
- If the ratio of the **smoothing account** to the sum of **unsmoothed asset shares** lies in the range -2% to -0.5%, payouts currently equal 95% of the average of **unsmoothed asset share** and the minimum of **unsmoothed asset share & smoothed asset share**.
- If the ratio of the **smoothing account** to the sum of **unsmoothed asset shares** lies in the range 0.5% to 2%, payouts currently equal 105% of the average of **unsmoothed asset share** and the maximum of **unsmoothed asset share & smoothed asset share**.
- If the ratio of the **smoothing account** to the sum of **unsmoothed asset shares** is greater than 2%, payouts currently equal 110% of the maximum of **unsmoothed asset share & smoothed asset share**.

In practice some additional flexibility is retained within the operation of these smoothing bands. An example of such a situation would be when the ratio of the **smoothing account** to the sum of **unsmoothed asset shares** moves marginally out of the -0.5% to 0.5% smoothing band, theoretically requiring payouts to be based on more or less than 100% of **smoothed asset shares**. If it is believed the ratio so calculated is likely to return shortly thereafter to the -0.5% to 0.5% smoothing band, payouts may continue to be based on 100% of **smoothed asset shares**.

4.4.6 Were the normal smoothing mechanisms described in 4.4.2 – 4.4.5 to jeopardise the solvency position of the **Firm**, payouts could then be allowed to fall further below 100% of **unsmoothed asset shares**. Payouts could also rise further above 100% of **unsmoothed asset shares** in order to avoid a **tontine effect** as the funds run down.

4.4.7 The **Firm** expects to review **final bonus** rates and **MVRs** quarterly. In times of significant market volatility, these reviews could become more frequent. Conversely, in times of stable markets, these reviews could become less frequent. The fact that

final bonus rates and **MVRs** are not normally reviewed on a daily basis implicitly introduces an additional element of smoothing.

4.4.8 The following overriding restrictions normally apply on the degree to which payouts may change on similar policies from one bonus declaration to the next:

- We would not normally allow **final bonus** rates under **traditional with profits** investments to increase by more than 15% or decrease by more than 5% from one quarterly rate review to the next.
- At the point of a quarterly rate review, we would not normally allow payouts under **unitised with profits** investments to increase or decrease by more than 7.5%.

In times of significant market volatility, rate reviews could be more frequent than quarterly (see 4.4.7).

4.4.9 Traditional With Profits (TWP)

4.4.9.1 **Final bonus** rates under **TWP** contracts apply at policy level, apart from certain group pension contracts where individual benefit “slices” can exist within a single policy, which then attract **final bonus** rates based on their individual characteristics.

4.4.9.2 On early surrender or transfer, formulaic calculations are applied to both the guaranteed maturity benefits (including accrued **annual bonus** additions) and any **final bonus** likely to be available at the rates then current, in order to derive a surrender or transfer value. These formulae, which require assumptions to be made about future investment returns, annual bonuses and mortality rates, will change from time to time. We expect to review the appropriateness of these formulae on an annual basis.

4.4.9.3 In calculating **final bonuses**, the **Firm** does not usually differentiate between claim types (e.g. between maturities, deaths and surrenders).

4.4.9.4 The **Firm** has set the following current target ranges around **unsmoothed asset share** for the maturity payments that it will make on **TWP** contracts.

TWP life contracts :	70% - 130%
TWP pensions contracts (regular premium) :	70% - 130%
TWP pensions contracts (single premium) :	70% - 130%

In setting these ranges, the **Firm** expects that 90% of maturity payments will fall within the ranges. In circumstances where a maturity payment falls outwith the appropriate range because there is an excess of **guaranteed benefits** above **smoothed asset share** at the point a claim arises, the claim value is deemed to fall within the appropriate range.

4.4.9.5 In setting **final bonus** rates and in demonstrating compliance with the target ranges in 4.4.9.4, small **TWP** contracts are normally excluded from the calculations. This is because **TWP asset shares** must allow for expenses that are fixed in accordance with the **Scheme** at levels that are independent of policy size. Were small contracts to be included in the calculation of final bonus rates, the **final bonus** rates (which apply to contracts of all sizes) would be unduly suppressed.

4.4.10 Unitised With Profits

- 4.4.10.1 Under **unitised with profits** policies, investments of similar durations across all policies within a **notional subfund** are grouped together for the purpose of calculating **final bonus** rates and/or **MVRs**. In practice, this means that a range of **final bonus** rates and/or **MVRs** can apply to individual investments within a single policy.
- 4.4.10.2 **Final bonus** rates and **MVRs** would normally be calculated based on year and month of investment. Accordingly, it is possible that both **final bonuses** and **MVRs** could apply within an individual policy if more than one investment had been made into that policy.
- 4.4.10.3 In calculating **final bonus** and/or **MVRs**, the **Firm** does not usually differentiate between claim types (e.g. between maturities, deaths and surrenders) other than to the degree that MVR-free terms exist.
- 4.4.10.4 **MVRs** may be applied on certain claims under the following **unitised with profits** funds : WPE, WPC, WWP, WP1, WP2, DAF, DA2 & WPB. No facility to apply **final bonus** or **MVRs** exists under Other Deposit Administration contracts and no facility to apply **MVRs** exists under Reflex Deposit Administration contracts.
- 4.4.10.5 When a partial withdrawal is made that exceeds the corresponding **smoothed asset share** on account of **MVR-free** terms being offered, the excess paid does not reduce the **smoothed asset share** associated with the remainder of the policy.
- 4.4.10.6 The **Firm** has set the following current target ranges around **unsmoothed asset share** for the maturity payments that it will make on each of its unitised with profits funds.

WPE, WPC, WWP, WP1, WP2, DAF, DA2 & WPB funds :	85% - 115%
Deposit Administration contracts :	80% - 120%

In setting these ranges, the **Firm** expects that 90% of maturity payments will fall within the ranges. In circumstances where a maturity payment falls outwith the appropriate range because there is an excess of **guaranteed benefits** above **smoothed asset share** at the point a claim arises, the claim value is deemed to fall within the appropriate range.

- 4.4.11 The **Firm** manages its with profits business with the longer-term aim that it will make aggregate maturity payments equal to 100% of **unsmoothed asset shares**. Any excess of **guaranteed benefits** above **smoothed asset shares** at the point a claim arises plays no part in the maintenance of this longer-term aim : for this purpose, relevant payouts are assumed to be equal to 100% of **smoothed asset shares**, subject to any increase or reduction in accordance with 4.4.5.

4.5 Costs of Guarantees and the Cost of Capital

4.5.1 Deductions for the Cost of Guarantees

- 4.5.1.1 **Stochastic** modelling techniques are used in order to assess the cost of **guaranteed annuity options (GAOs)** and **guaranteed minimum pensions (GMPs)**, which involve the simulation of future investment returns and interest rates. By running a large number of simulations, the

expected cost of **GAOs & GMPs** arising at the point of vesting can be determined.

4.5.1.2 **Stochastic** modelling techniques are also used in order to assess the cost of with profits growth guarantees. This involves the simulation of future investment returns, which enables a comparison to be made of **asset shares** against **guaranteed benefits** at guaranteed points. By running a large number of simulations, the expected cost of shortfalls arising at the guarantee points can be determined.

4.5.1.3 In arriving at **asset shares** (and having regard, generally, to investment returns available to be applied thereto), a monthly deduction is made from the investment return underpinning the calculation of the **asset shares** of all with profits policies offering investment guarantees that covers part of the combined expected future cost of **GAOs, GMPs** and with profits growth guarantees. The balance of the expected future costs is met from the **estate**.

4.5.1.4 The level of deduction described in 4.5.1.3 can be varied from time to time although no retrospective alterations would be made at the point of change.

We would expect to discuss the ongoing level of deduction, from time to time, with FSA.

4.5.1.5 Subject to a regular assessment of economic conditions, the expected emergence of guarantee costs and the level of **excess regulatory capital** in the **WPSF** (see 3.10.2), the **Firm** aims to enhance the investment returns underpinning the calculation of **asset shares** from the **estate**. Subject to the provisions of 4.10.6 – 4.10.8, the **Firm** would currently expect the level of enhancement from the estate to exceed any deductions for guarantee costs made in accordance with 4.5.1.4 above.

4.5.2 Cost Of Capital Support

4.5.2.1 Capital support may be required, for example, to meet regulatory requirements or to allow greater investment freedom. Further deductions may be made from the investment returns applicable to the determination of **asset shares**, from time to time, to help meet the cost of providing this capital support.

4.5.2.2 No such deductions are currently being incorporated within the calculation of **asset shares**.

4.6 The Approach to Smoothing

4.6.1 The normal process underpinning the calculation of **smoothed asset shares** within each **notional subfund** is as follows -

4.6.1.1 **Smoothed asset shares** are dependent on the relationship between **unsmoothed asset shares** and corresponding “policy values”. Under **unitised with profits** policies, “policy value” reflects the nominal value of units; under **traditional with profits** policies it reflects the **guaranteed benefits** at maturity, including annual bonus additions to date, assuming that all contractual premiums are paid.

4.6.1.2 Under investments that have been in force for 2 whole years or more, **smoothed asset shares** are dependent on the actual policy

value/**unsmoothed asset share** relationship at the point of calculation and over the previous 2 years and the expected policy value/**unsmoothed asset share** relationship over the next 2 years.

4.6.1.3 Under investments that have been in force for 1 whole year, **smoothed asset shares** are dependent on the actual policy value/**unsmoothed asset share** relationship at the point of calculation and over the previous year and the expected policy value/**unsmoothed asset share** relationship over the next year.

4.6.1.4 In the calculation of **smoothed asset shares**, no smoothing takes place on investments that have been in force for less than 1 year.

4.6.1.5 In the calculation of **smoothed asset shares**, any estimates of future investment return are consistent with the asset mix of the subfund in question, after adjusting for charges/expenses, tax and for contributions towards the expected cost of guarantees and cost of capital as appropriate. Similarly, the corresponding estimates of "policy value" require assumptions to be made about future bonus rates that are consistent with the practices detailed in section 4.3.

4.6.1.6 The implication of paragraphs 4.6.1.1 – 4.6.1.5 is that, depending on the in-force duration, we normally allow for smoothing by averaging the actual investment returns in the 1-2 years immediately prior to a claim being made with the expected investment returns in the 1-2 years immediately after.

4.6.2 The **Firm** maintains a **smoothing account**. Positive contributions are made to the **smoothing account** if payouts to policyholders are less than **unsmoothed asset shares** and vice-versa. The exception to this is where payouts equal **guaranteed benefits** and **guaranteed benefits** exceed **unsmoothed asset shares**. In this circumstance, the excess cost above the payout that would otherwise be made in the absence of guarantees is met from the **estate**.

4.6.3 Within each **notional subfund**, the same smoothing strategy applies to all generations of policyholders.

4.7 Investment Strategy

4.7.1 Assets within the **WPSF** fall into one of the following sectors -

- UK equities
- Overseas equities
- Fixed interest
 - (1) Backing **asset shares**
 - (2) Within the **estate**
 - (3) Backing **New Generation With Profits** (see sections 5 & 6)
- Property
- Cash
- Others

4.7.2 Each of the **notional subfunds** within the **WPSF** buys "units" in each of the above sectors. Hence for the purpose of calculating **asset shares**, the characteristics, in particular the investment returns, of (say) the UK equities & fixed interest securities (1) held by each **notional subfund** are identical.

4.7.3 The **Firm** aims to match expected future guaranteed cashflows across the whole portfolio of **WPSF** liabilities (excluding the WP2 & WPB funds – see 4.1.3) with

interest and capital payments from its block of fixed interest securities. The fixed interest return credited to the **asset shares** of all with profits policies is consistent with the weighted average investment return across the entire **WPSF** fixed interest (1) portfolio.

- 4.7.4 The **Firm's** general policy is to hold an appropriate spread of assets between **counterparties** in order to reduce risk. Additionally, the **Firm** would normally expect at least 95% of its fixed interest securities to have credit ratings of BBB or higher. The **Firm** would not normally expect to become a forced seller of fixed interest securities should credit ratings on investments held fall from BBB or higher to below BBB.
- 4.7.5 The **Firm** would not normally invest in assets of sufficient concentration that would cause **regulatory admissibility limits** to be breached.
- 4.7.6 Any substantial investment in new or novel investment instruments would require the approval of the Board.
- 4.7.7 The **Firm** would not usually expect to invest in assets that would not normally be traded.
- 4.7.8 Each of the **notional subfunds** has a target range for the percentage of the backing assets that are normally invested in a combination of equities and property [**"equity backing ratio" (EBR)**]. Current target **EBRs** are as follows -
- TWP, WPE, WPC & WWP : 15% - 20%**
WP1, DAF & DA2 : 17.5% - 22.5%
WP2 & WPB : 52.5% - 57.5%
Deposit Administration : 0%
- These ranges may vary from time to time, as the **Firm** deems appropriate. A table of current asset mixes by **notional subfund** is available on the **Firm's** website and will be updated every three months. Any significant change in asset mixes will be communicated separately to individual policyholders.
- 4.7.9 The **Firm** would normally expect the overseas component of its equity investments to lie within the range 10% - 25%, with the exception of the WP1, DAF & DA2 funds, where there is normally no overseas equity exposure. Additionally, it would normally expect to hedge all overseas currency risk under non-sterling denominated fixed interest securities.
- 4.7.10 The conditions in which it may be appropriate to utilise **derivatives** are given in section 3.7.3. The control environment for the use of **derivative** instruments involves: approval by a senior investment manager that the initial investment is within permitted parameters; segregation of duty between those who authorise deals and those who trade deals; and monthly discussion of **derivative** reports.
- 4.7.11 Formal reviews of the investment strategy of each subfund would normally be made half-yearly.
- 4.7.12 Any transfer of assets to the **WPSF** for the purpose of maintaining the **Firm's** investment strategy in the **WPSF** must be in accordance with the terms of the **Scheme**.

4.8 Business Risk

- 4.8.1 From 1 January 1994 the **WPSF** has not been exposed to any of the business risks associated with the writing of new policies. All such risks are borne by the **NPSF**.

4.8.2 The way in which historic guarantees impact on the calculation of **asset shares** is detailed in section 4.5.

4.8.3 Any currently unrecognised business risks that might fall to the **WPSF** could impact on future returns to with profits policyholders. This would depend on the nature of any such risks and their size.

4.9 Management & Administration Expenses

4.9.1 Traditional With Profits (TWP)

The deductions from **asset shares** are defined in the **Scheme**. For regular premium & single premium/paid-up policies, the **Scheme** specifies the levels to apply from 1 January 1994, which then increase each year thereafter in line with National Average Earnings.

Further deductions are made for investment related expenses in a manner that the **Firm** deems appropriate in accordance with the approach set out in the **Scheme**. The level of deduction made, as a percentage of the assets under management, is determined in arrears.

4.9.2 Unitised With Profits

As per the **Scheme**, an annual management charge is taken from **asset shares** at a rate equal to that taken from equivalent unit-linked funds, a common rate of which is currently 1% per annum.

4.9.3 The risk that expenses exceed the levels as calculated in 4.9.1 or the annual management charge as calculated in 4.9.2 is borne by the **NPSF**.

4.10 Management of the Inherited Estate

4.10.1 The **inherited estate** has been used to cover the cost of all investment guarantees (including **GAO** & **GMP** guarantees) incurred prior to 1 January 2004.

4.10.2 The cost of guarantees arising in connection with **GAOs**, **GMPs** and with profits growth guarantees from 1 January 2004 onwards will be partially met from the **estate** (see 4.5.1).

4.10.3 The **inherited estate** may be used to meet other costs of appropriate guarantees and business risks if and when they arise in future or to enhance payouts.

4.10.4 The investment policy for the **inherited estate** is driven by the nature of the assets & liabilities in the **WPSF**, with the aim of ensuring that the **estate** is not unduly exposed to individual risks.

4.10.5 The **estate** has been used to purchase **interest rate swaps & swaptions** as the **WPSF** has exposure to interest rate falls (for example, on its **GAO** liabilities). The **estate** has also been used to purchase **equity put options** in connection with with-profits growth guarantees.

4.10.6 The **Firm** aims to distribute the **estate** equitably to with profits policyholders over time. Subject to an annual assessment of economic conditions, the expected emergence of guarantee costs and the level of **excess regulatory capital** in the **WPSF** (see 3.10.2), this will normally be achieved through an increase to the

investment return underpinning the calculation of **asset shares**. A review of the appropriate level of increase will normally be made on an annual basis.

4.10.7 The appropriate level of such an increase for a particular calendar year will normally be determined at the end of that year.

4.10.8 The **Firm** expects that, over the long-term, the increases referred to in 4.10.6 will exceed the deductions referred to in 4.5.1, resulting in a net increase in the investment return underpinning the calculation of **asset shares**. However, this is not guaranteed and will depend on the factors highlighted in 4.10.6. In particular, fluctuations in the level of increase could occur on an annual basis.

4.11 Volumes of New Business and Arrangements on stopping taking New Business

4.11.1 No new with profits business with investment guarantees is written in the **WPSF**, apart from, potentially, increments, renewal premiums and single premiums under policies in-force as at 30 September 2002 and new entrants to occupational pension schemes that were in force as at 30 September 2002.

4.12 Equity between the With Profits Fund and the Shareholder

4.12.1 In accordance with the **Scheme**, the **shareholder** does not participate in any profits arising in the **WPSF**.

SCOTTISH EQUITABLE plc

5. PRINCIPLES OF FINANCIAL MANAGEMENT OF WITH PROFITS BUSINESS FUNDS WITHOUT INVESTMENT GUARANTEES

5.1 General

- 5.1.1 With profits funds without investment guarantees are written by the **Firm**. These funds are known as the "**New Generation With Profits (NGWP) Funds**" and were launched on 30 September 2002.
- 5.1.2 These funds have different Principles and Practices to other with profits business. This is consistent with their structure, which contains no investment guarantees and under which payouts are not affected by guarantee costs on other with profits business. **NGWP** is classified as Class III insurance business (linked long term) within the calculation of the **Firm's regulatory solvency requirements**.
- 5.1.3 The assets within each **NGWP** fund are ring-fenced from other **NGWP** funds and from other **notional subfunds** within the **Firm**.
- 5.1.4 There are four **NGWP** funds : Life Growth, Life Cautious, Pensions Growth & Pensions Cautious. Additionally, similar life funds sold by AEGON Scottish Equitable International plc are reinsured into the **Firm**. **Stakeholder** equivalent versions of the Pensions Growth & Pensions Cautious funds also exist.
- 5.1.5 The **stakeholder** funds are subject to **stakeholder** provisions, which are not set out in this document.

5.2 The Amount Payable under a With Profits Policy

- 5.2.1 There is no concept of **annual bonuses**, **final bonuses** or **market value reductions** under any of the **NGWP** funds.
- 5.2.2 Policyholder benefits are determined by reference to a unit price, which is published daily.
- 5.2.3 The unit price for each **NGWP** fund is based on the following :
- 5.2.3.1 The actual return earned on the backing assets (net of tax where appropriate).
 - 5.2.3.2 The long-term expected growth rate for the fund in question.
 - 5.2.3.3 Smoothing profits and losses that arise on claims.
 - 5.2.3.4 The level of annual management charge.
- 5.2.4 In certain circumstances, "smoothing adjustments", which may be positive or negative, may be applied to claim values in order to ensure equity amongst participating policyholders and to maintain fund stability.
- 5.2.5 Any changes to the methods used to set payouts require the approval of the Board.
- 5.2.6 No changes would normally be made to any historic assumptions or parameters underpinning the calculation of unit prices or smoothing adjustments, unless an error was subsequently discovered.

5.3 The Approach to Smoothing

- 5.3.1 The impact of smoothing is reflected in the combination of the unit price and any smoothing adjustments that might apply. As only assets within each **NGWP** fund are available to meet claims as they fall due, the cost of smoothing will be neutral over the lifetime of each fund.
- 5.3.2 A more favourable approach to smoothing may be adopted on certain types of claim as opposed to others (for example, deaths and maturities may be treated more favourably than surrenders).

5.4 Investment Strategy

- 5.4.1 The investment strategy under each individual **NGWP** fund is consistent with representations made to policyholders (e.g. in Key Features documents), in particular regarding the proportion of the fund that will be invested in real assets (equities & property) – the **equity backing ratio (EBR)**.
- 5.4.2 The target **EBRs** for the Growth Funds are higher than the corresponding Cautious Funds.
- 5.4.3 The **Firm** does not rely on assets outwith each individual **NGWP** fund in order to maintain the investment strategy within the fund.
- 5.4.4 It may be appropriate to utilise **derivatives** to protect the **NGWP** funds against adverse market movements (e.g. equity falls or changes in fixed interest yields). It may also be appropriate to utilise **derivatives** for short-term asset allocation purposes or to increase diversification by gaining exposure to different asset classes or for efficient portfolio management.
- 5.4.5 Exposures to individual **counterparties** (including **derivative** exposures) across the entire **Firm** would not normally exceed **regulatory admissibility limits**. An appropriate spread of assets between **counterparties** will be held in order to reduce risk.
- 5.4.6 The **NGWP** funds would not usually expect to invest in assets that would not normally be traded because of their importance to the **Firm**.

5.5 Business Risk

- 5.5.1 The **NGWP** funds are not exposed to any of the business risks associated with the writing of new policies. All such risks are borne by the **NPSF**.
- 5.5.2 The capital required to cover **regulatory solvency requirements** on **NGWP** business is held in the **NPSF**.

5.6 Charges and Expenses

- 5.6.1 All expenses are met by the **NPSF**.
- 5.6.2 An annual management charge is paid out of the **NGWP** funds to the **NPSF**. In accordance with policy conditions and the **Scheme**, the level of charge is equal to that taken from equivalent unit-linked funds. Apart from on certain business lines, charges can be reviewed from time to time.

5.7 Management of the Inherited Estate

5.7.1 The level of **inherited estate** has no impact on payouts to **NGWP** policyholders.

5.8 Volumes of New Business and Arrangements on stopping taking New Business

5.8.1 New business volumes have no direct impact on payouts to **NGWP** policyholders.

5.9 Equity between the With Profits Fund and the Shareholder

5.9.1 The **shareholder** has no financial interest in the **NGWP** funds beyond the annual management charge taken by the **NPSF**.

SCOTTISH EQUITABLE plc

6. PRACTICES OF FINANCIAL MANAGEMENT OF WITH PROFITS BUSINESS FUNDS WITHOUT GUARANTEES

6.1 General

- 6.1.1 Since 30 September 2002, all new with profits business has been written into the "**New Generation With Profits (NGWP)**" Funds.
- 6.1.2 No investment guarantees exist under the **NGWP** funds.
- 6.1.3 The **NGWP** funds on offer are : Life Growth, Life Cautious, Pensions Growth & Pensions Cautious. Additionally, similar life funds sold by AEGON Scottish Equitable International plc are reinsured into the **WPSF Stakeholder** equivalent versions of the Pensions Growth & Pensions Cautious funds also exist.

6.2 The Amount Payable under a With Profits Policy

- 6.2.1 There is no concept of bonuses under the **NGWP** funds and a smoothed unit price is calculated on a daily basis for each fund, which depends on the actual return achieved relative to a published expected return plus the daily smoothing profits and/or losses that arise on claims.
- 6.2.2 The unit price can fall as well as rise.
- 6.2.3 Expected long-term growth rates are agreed for the funds. These can be varied prospectively (they would normally be subject to an annual review and require Board approval were they to change). Expected growth rates are before deduction of the annual management charge. In the case of the Life Growth & Cautious funds, they are after deduction of an estimate of the amount of tax payable under the funds.
- 6.2.4 The expected rates in 6.2.3 are then converted to daily equivalent rates and compared with the actual earned rate on each day (in the case of the Life funds, after deduction of an estimate of the amount of tax payable). The unit price then increases/decreases on a daily basis by the expected daily growth plus/minus 50% of the difference between the actual and expected growth less the daily equivalent rate of annual management charge. The figure of 50% can be varied, subject to Board approval.
- 6.2.5 On each individual day, a smoothing profit or loss will occur on claims depending on the difference between the smoothed unit value and the underlying unsmoothed value of the backing assets. Consistent with 6.2.4, 50% of any smoothing profit or loss is currently fed back into the calculation of the unit price.
- 6.2.6 Claim values may be adjusted by "**smoothing increases**" or "**smoothing reductions**" in certain circumstances. This is necessary to ensure that payouts to policyholders are fair in all circumstances.
- 6.2.7 No **smoothing increases** or **reductions** will currently be applied on claims under any of the **NGWP** funds providing that, at **cohort** rather than individual policy level, the ratio of smoothed unit value to the unsmoothed value of the backing assets is in the range 80% to 130%.

6.3 Investment Strategy

- 6.3.1 Assets within the **WPSF** fall into one of the following sectors -

- UK equities
- Overseas equities
- Fixed interest
 - (1) Backing **asset shares**
 - (2) Within the **estate**
 - (3) Backing **NGWP**
- Property
- Cash
- Others

6.3.2 Each of the **NGWP** funds within the **WPSF** buys “units” in each of the above sectors. Hence for the purpose of calculating investment returns and smoothed unit prices, the characteristics of (say) the UK equities & fixed interest securities (3) held by each **NGWP** fund are identical.

6.3.3 The fixed interest returns credited to each **NGWP** fund are consistent with the weighted average investment return across the entire **WPSF** fixed interest (3) portfolio, including those securities held in connection with funds that offer investment guarantees. The characteristics of the fixed interest portfolio are driven by the matching policy detailed in section 4.7.3.

6.3.4 The **Firm’s** general policy is to hold an appropriate spread of assets between **counterparties** in order to reduce risk. Additionally, the **Firm** would normally expect at least 95% of its fixed interest securities to have credit ratings of BBB or higher. The **Firm** would not normally expect to become a forced seller of fixed interest securities should credit ratings on investments held fall from BBB or higher to below BBB.

6.3.5 The **Firm** would not normally invest in assets of sufficient concentration that would cause **regulatory admissibility limits** to be breached across the entire **Firm**.

6.3.6 Any investment in new or novel investment instruments would require the approval of the Board.

6.3.7 The **NGWP** funds would not usually expect to invest in assets that would not normally be traded.

6.3.8 Each of the **NGWP** funds has a target range for the level of investment in each asset class. Current target ranges are as follows -

6.3.8.1 *Life Growth & Pensions Growth*

UK & Overseas Equities : 60% - 90%
 UK & Overseas Fixed Interest : 10% - 40%
 Cash & Others : 0% - 5%

6.3.8.2 *Life Cautious & Pensions Cautious*

UK & Overseas Equities : 20% - 50%
 UK & Overseas Fixed Interest : 30% - 70%
 Property : 0% - 25%
 Cash & Others : 0% - 5%

These ranges may vary from time to time, as the **Firm** deems appropriate. A table of current asset mixes by **NGWP** fund is available on the **Firm’s** website and will be updated every three months. Any significant change in asset mixes will be communicated separately to individual policyholders.

- 6.3.9 The **Firm** would normally expect the overseas component of its equity investments to lie within the range 10% - 25%. Additionally, it would normally expect to hedge all overseas currency risk under non-sterling denominated fixed interest securities.
- 6.3.10 The conditions in which it may be appropriate to utilise **derivatives** are given in section 5.4.4. The control environment for the use of **derivative** instruments involves: approval by a senior investment manager that the initial investment is within permitted parameters; segregation of duty between those who authorise deals and those who trade deals; and monthly discussion of **derivative** reports.
- 6.3.11 Formal reviews of the investment strategy of each **NGWP** fund would normally be made half-yearly.
- 6.3.12 No transfer of assets can be made from outwith the **NGWP** funds for the purpose of maintaining the investment strategy in the **NGWP** funds.

6.4 Business Risk

- 6.4.1 The **NGWP** funds are not exposed to any of the business risks associated with the writing of new policies. All such risks are borne by the **NPSF**.

6.5 Charges and Expenses

- 6.5.1 As per the **Scheme**, an annual management charge is taken from the **NGWP** funds at a rate equal to that taken from equivalent unit-linked funds.
- 6.5.2 The risk that expenses exceed the annual management charge is borne by the **NPSF**.

6.6 Management of the Inherited Estate

- 6.6.1 The level of **inherited estate** has no impact on payouts to **NGWP** policyholders.

6.7 Volumes of New Business and Arrangements on stopping taking New Business

- 6.7.1 The **NGWP** funds generate no capital strains in the **WPSF** nor do they participate in any **inherited estate**. Consequently, there are no restrictions on the volumes of such business that may be written.

6.8 Equity between the With Profits Fund and the Shareholder

- 6.8.1 In accordance with the **Scheme**, the **shareholder** has no financial interest in the **NGWP** funds beyond the routine level of annual management charges taken.

SCOTTISH EQUITABLE plc
7. GLOSSARY OF TERMS WITHIN PRINCIPLES & PRACTICES OF
FINANCIAL MANAGEMENT OF WITH PROFITS BUSINESS

<i>Annual Bonuses :</i>	Amounts, which when added to policies, constitute guarantees at specific points in time as per the Policy Conditions. Bonus rates are normally reviewed annually.
<i>Asset Shares :</i>	Used as a guide to setting bonus rates – see 4.2. Sometimes referred to as <i>Unsmoothed Asset Shares</i> .
<i>Capital Contributions :</i>	Contributions made by the shareholder to the WPSF since 31 December 1993 in return for an increasing share (now 100%) of future profits on unitised and non-profit business.
<i>Cohorts of Policyholders :</i>	Groups of policyholders with similar characteristics (e.g. same year and month of policy commencement or premium payment).
<i>Contract Charges :</i>	Charges as defined in the Policy Conditions (e.g. an annual management charge). Market Value Reductions are <u>not</u> included in this definition.
<i>Counterparty :</i>	An organisation or individual with which the Firm has made investments or against whom it has rights whether in pursuance of a contract entered into by the insurer or otherwise.
<i>Derivatives :</i>	Financial instruments that are either contracts for differences, futures or options.
<i>Equity Backing Ratio (EBR) :</i>	The proportion of assets invested in a mix of equities and property.
<i>Equity Put Options :</i>	Derivative contracts that give the right to sell equities at a pre-determined price and therefore provide protection against falls in equity markets.
<i>Estate :</i>	See Inherited Estate.
<i>Excess Regulatory Capital :</i>	The excess of assets over the sum of liabilities and the regulatory solvency requirements.
<i>Final Bonuses :</i>	Non-guaranteed amounts that may be added to guaranteed benefits (including annual bonus additions) when a claim arises.
<i>Firm :</i>	Scottish Equitable plc.
<i>GMP Guarantees :</i>	Guarantees provided by the WPSF under certain Buyout contracts relating to the purchase of Guaranteed Minimum Pensions (GMPs) at state pension age.

<i>Guaranteed Benefits :</i>	Amounts guaranteed to be paid at specific points in time in accordance with the Policy Conditions at the point of payment of a premium or a series of premiums.
<i>Guaranteed Annuity Options :</i>	An option, which exists under certain pension contracts, to convert the fund available at retirement to an annuity on guaranteed terms as set out in the Policy Conditions.
<i>Inherited Estate :</i>	The excess, on a realistic basis, of assets within the WPSF over and above the amount required to meet liabilities.
<i>Interest Rate Swaps :</i>	The exchange of unknown series of future cashflows for certain series of future cashflows at specified future dates (and vice-versa).
<i>Interest Rate Swaptions :</i>	In this instance, options to exchange unknown series of future cashflows for certain series of future cashflows at specified future dates.
<i>Investment Element :</i>	That part of a unitised with profits policy on which guaranteed benefits, annual bonuses, final bonuses and market value reductions are based.
<i>Long-Term Insurance Fund :</i>	A fund maintained in accordance with FSA rules into which long-term insurance business must be written.
<i>Market Value Reductions (MVRs) :</i>	A reduction in the value of units under a unitised with profits policy that may apply when a claim arises at a point where no guarantee exists.
<i>New Generation With Profits :</i>	With profits funds under which there is no concept of annual or final bonuses, with benefits being determined by reference to a smoothed unit price that normally changes on a daily basis.
<i>Non Profit Subfund (NPSF) :</i>	That part of the Firm's long-term insurance fund into which no with profits business is ultimately written.
<i>Notional Subfund :</i>	A notional subdivision of the WPSF into a smaller fund with specific characteristics (e.g. a different rate of guaranteed growth to other notional subfunds). Bonus declarations are specific to each notional subfund.
<i>Regulatory Admissibility Limits :</i>	Limits specified by the Financial Services Authority relating to the maximum amounts of specific asset types (and counterparty exposures) that can be counted towards solvency purposes.
<i>Regulatory Solvency Requirements :</i>	The minimum excess of assets over liabilities that must be maintained in accordance with the requirements of the Financial Services Authority.
<i>Scheme :</i>	The legal document approved by the Court of Session that authorised and gave effect to the transfer of business from Scottish Equitable Life Assurance Society to the Firm with effect from 31 December 1993.

<i>Shareholder :</i>	AEGON nv.
<i>Smoothed Asset Shares :</i>	Asset shares adjusted for smoothing of investment returns, which are then used as a guide to setting bonus rates.
<i>Smoothing Account :</i>	The degree to which payouts, over time, have deviated from unsmoothed asset shares. If the account is positive, payouts have, in total, been less than unsmoothed asset shares and <u>vice versa</u> .
<i>Smoothing Reductions & Increases :</i>	Can only apply under the New Generation With Profits Funds. May be applied to claim values in order to ensure equity amongst participating policyholders and to maintain fund stability.
<i>Stakeholder Business:</i>	A pension scheme established in accordance with the Stakeholder Pension Schemes Regulations 2000.
<i>Stochastic Modelling :</i>	The simulation of future outcomes (e.g. investment returns) using financial models that can be used to assess the likelihood of specific events occurring.
<i>Tontine Effect :</i>	The effect associated with a declining fund, where the last remaining policyholder is entitled to the remaining surplus in the fund.
<i>Traditional With Profits (TWP) :</i>	A with profits policy that, in accordance with the Policy Conditions, offers a level of guaranteed benefit in return for the payment of a premium or an agreed series of premiums. Offers no facility to switch into a unit-linked contract.
<i>Unitised With Profits :</i>	A with profits policy that, in accordance with the Policy Conditions, offers a level of guaranteed benefit (with the exception of New Generation With Profits) linked to the payment of each individual premium. Guaranteed benefits (including annual bonus additions) are expressed in terms of a unit value. Generally, it offers the facility to switch into a unit-linked contract (but not always).
<i>Unsmoothed Asset Shares :</i>	See <i>Asset Shares</i> .
<i>With Profits Actuary :</i>	An actuary appointed under Chapter 4 of the Supervision Manual of the Financial Services Authority.
<i>With Profits Subfund (WPSF) :</i>	That part of the Firm's long-term insurance fund into which all with profits business is ultimately written.