

For customers

# Scottish Equitable plc 2010 annual report to with-profits investors

For the year to 31 December 2010

March 2011

# Scottish Equitable and with-profits

In this report you can find details of how we managed our with-profits business in 2010 and how we took account of our with-profits investors' interests.

## About this report

The Financial Services Authority (FSA) requires us, Scottish Equitable plc, to produce a report each year for our with-profits investors stating whether or not, during the financial year in question, we believe we've complied with our stated Principles and Practices of Financial Management of With-Profits Business (PPFM).

But it's not just our word on it. The independent Scottish Equitable Policyholders Trust Ltd is involved in the ongoing assessment of our compliance with the PPFM, providing an element of independent judgement throughout the process. (You can find more details on this in the section 'How we make sure we're compliant with the PPFM' on the next page.)

## Our PPFM

Our PPFM sets out in detail our with-profits management strategy and processes. You can view it on our website at [www.aegonse.co.uk](http://www.aegonse.co.uk) or write to us at AEGON, Edinburgh Park, Edinburgh EH12 9SE for a copy.

Our PPFM is split into two sections: Principles and Practices. The Principles set out our general approach to the management of with-profits business and we don't expect these to change often. The Practices cover the day-to-day operation of our with-profits business within the Principles framework.

Customer-friendly versions of the PPFM are also available.

## Our with-profits contracts and funds

Scottish Equitable plc used to be Scottish Equitable Life Assurance Society, which was a mutual company, and you may have invested in your with-profits contract or fund with us then. On 31 December 1993 the business and assets of Scottish Equitable Life Assurance Society were transferred to Scottish Equitable plc as part of the demutualisation process as we became a public limited company. Scottish Equitable plc is owned by AEGON.

We have three types of with-profits contracts/funds:

- traditional with-profits
- unitised with-profits
- new generation with-profits

We generally offered traditional with-profits contracts up to 1984 for pensions business (for example retirement annuities) and 1991 for life business (for example endowments). We then had unitised with-profits funds available under contracts taken out after these dates up to 30 September 2002. Since then we've offered our new generation with-profits funds.

We included minimum pension guarantees (including guaranteed annuity options) in a number of contracts mainly in the 1970s and 1980s. As people are now on average living longer and interest rates have fallen over time, the cost of meeting these minimum guarantees has increased. While we've made investments that provide some protection against the impact of future interest rate falls, these guarantees still have an effect on the bonuses paid out to our with-profits investors, except for those invested in the new generation with-profits funds.

Apart from ongoing regular contributions, increments and new entrants into existing occupational pension schemes, we stopped offering with-profits business with investment guarantees on 30 September 2002. Since then, any new with-profits investments have been into our range of new generation with-profits funds. These have no investment guarantees and each is ring-fenced, which means that all investment profits and losses stay in the fund and are reflected in payouts to investors.

To ensure fair outcomes for customers, a one-off programme has been set up by us to identify, investigate and, where appropriate, correct historic administrative and procedural errors. To date, work under this programme has shown that certain with-profits policyholders have been affected by such errors. A significant number of these errors have been addressed and where redress is due, payments have either been made to policyholders or policyholder benefits have been enhanced. We're continuing to address the outstanding errors as a matter of priority.

## **How we make sure we're compliant with the PPFM**

We take advice from the With-Profits Actuary on all aspects of the operation of our with-profits business. This ranges from bonus declarations to the systems and procedures needed to treat with-profits investors fairly. The With-Profits Actuary advises us on whether any changes we make are consistent with our PPFM and produces routine reports for us. One of these is a detailed report explicitly covering compliance with the PPFM during the previous financial year.

Also, the Scottish Equitable Policyholders Trust Ltd provides an element of independent judgement on compliance with the PPFM. Its board (which is independent of Scottish Equitable plc) meets regularly throughout the year and its directors take advice from an independent actuarial adviser (who also sits on the board of Scottish Equitable Policyholders Trust Ltd). The With-Profits Actuary is present at these regular meetings, as well as certain directors and management of Scottish Equitable plc. All reports from the With-Profits Actuary to Scottish Equitable plc's directors are also given to Scottish Equitable Policyholders Trust Ltd. As a matter of course during the year, the With-Profits Actuary routinely discusses matters with the independent actuarial adviser.

# Our with-profits decisions

Within our with-profits business, we have discretion (in other words we make all the decisions as to what to do) in the following key areas:

## Traditional and unitised with-profits business

- Investment policy
- The calculation of yearly bonus rates, final bonus rates and market value reductions
- The calculation of surrender values (for traditional with-profits contracts only)
- Deductions for meeting part of the expected future costs of guarantees within the calculation of asset shares (we calculate an asset share for each policy and it's basically the income (for example the contributions paid in) less the outgoings (for example contract charges) plus the underlying investment return)
- How much is added to the asset shares from the estate (which is the excess assets over and above the amount required to meet liabilities to investors)

## New generation with-profits business

- Investment policy
- The calculation of expected growth rates (which is what we expect the long-term return on the investments for each fund to be)
- The calculation of smoothing adjustments (which are adjustments, upwards or downwards, that may apply to your payout when you leave the fund)

In line with the demutualisation process, as described in the 'Our with-profits contracts and funds' section above, the expenses or charges allocated to asset shares are set at specific levels. If you've invested in unitised or new generation with-profits funds, you can find details of the charges in your illustration and policy conditions booklet. If you've invested in traditional with-profits contracts, details of the expenses are in our Scheme of Demutualisation.

## Investment policy

You can find the target investment ranges for traditional, unitised and new generation with-profits business, which have remained unchanged since the end of 2003, in the PPFM (and listed below). The target ranges specify how much of each fund is to be invested in a combination of equities (company shares) and property, with the balance to be invested in fixed interest securities and cash. Throughout 2010 with-profits investment mixes were within these target investment ranges, with the exception of occasional timing issues caused by substantial short-term changes in equity markets. For example, certain funds had their target upper bounds exceeded at 31 March 2010, but the positions were corrected in April 2010. This had no material impact on policyholders.

### Traditional and unitised with-profits contracts/funds

Target amounts to be invested in equities and property:

Traditional with-profits	15-20%
Unitised with-profits – WPE, WPC and WWP funds	15-20%
Unitised with-profits – WP1, DAF and DA2 funds	17.5-22.5%
Unitised with-profits – WP2 and WPB funds	52.5-57.5%
Unitised with-profits – Deposit Administration funds	0%

Under these funds, the higher the level of guarantees for investors, the lower the target equity/property range generally.

### New generation with-profits funds

#### Life Growth, Pensions Growth and Pensions

##### Stakeholder Growth

UK and overseas equities	60-90%
UK and overseas fixed interest	10-40%
Cash and others	0-5%

#### Life Cautious, Pensions Cautious and Pensions Stakeholder Cautious

UK and overseas equities	20-50%
UK and overseas fixed interest	30-70%
Property	0-25%
Cash and others	0-5%

The gross investment returns (before deducting tax and expenses/charges and before adding an amount from the estate) over the last two years under the traditional and unitised with-profits contracts/funds are shown below. These investment returns feed directly into the calculation of asset shares, which are used to set the bonus rates and market value reductions that determine payouts to policyholders. Note that these returns don't represent changes in the value of with-profits policies to investors. When we set bonus rates and market value reductions, asset shares are smoothed.

<b>Contract/Fund</b>	<b>2010 returns</b>	<b>2009 returns</b>
Traditional Life and Pensions, Unitised Pensions WPE, Life WPC, Life WWP	12.3%	13.5%
Unitised Pensions WP1	11.5%	13.3%
Unitised Pensions WP2	13.6%	17.3%
Unitised Pensions DAF	11.5%	13.4%
Unitised Pensions DA2	11.5%	13.4%
Unitised Pensions Deposit Administration	10.3%	11.1%
Unitised Life WPB	13.6%	17.3%

Good investment returns were experienced in all funds in 2010, consistent with positive market conditions, particularly in the second half of 2010. The highest returns were in the funds with the highest equity contents (WP2 and WPB).

The new generation with-profits funds use a smoothed unit price to share out their profits and losses to investors, unlike traditional with-profits contracts and unitised with-profits funds, which use a system of yearly bonuses and final bonuses or reductions. The change in smoothed unit price for the new generation with-profits funds over the last two years is shown below.

	<b>2010 unit price change</b>	<b>2009 unit price change</b>
Life Growth fund	9.1%	10.4%
Life Cautious fund	8.0%	8.5%
Pensions Growth fund	10.2%	12.6%
Pensions Cautious fund	8.7%	9.6%
Pensions Stakeholder Growth fund	10.3%	12.7%
Pensions Stakeholder Cautious fund	8.6%	9.7%

The unit price changes in all new generation with-profits funds during 2010 substantially reflect the average of the underlying asset returns and the expected growth rates, which are detailed later in this report.

## Yearly bonus rates, final bonus rates and market value reductions (MVRs)

Asset shares are fundamental to the calculation of yearly bonus rates, final bonus rates and MVRs. You can find details of how we'll calculate asset shares in the PPFM, which we followed during 2010.

Once we've calculated the asset shares, they're then smoothed, using a process described in the PPFM, to arrive at smoothed asset shares. We calculated smoothed asset shares in line with the PPFM throughout 2010.

The PPFM details the circumstances in which final bonus rates and MVRs might be based on something other than 100% of smoothed asset shares. Final bonus rates and MVRs, which are reviewed every three months, were based on around 95% of smoothed asset shares during the first six months of 2010 and on 100% of smoothed asset shares thereafter. The approach in the first half of the year was because accumulated historic smoothing losses exceeded a limit specified in the PPFM, which in turn, then requires additional downwards smoothing. Every three months we update final bonus rates and MVRs on our website.

We declared yearly bonus rates on 1 April 2010 for those funds where the bonus is declared in advance and on 31 December 2010 for those funds where the bonus is declared in arrears. This was done in line with the PPFM. You can find the declared yearly bonus rates below, with the previous year's rates for comparison.

Yearly bonus declared in advance	1 April 2010	1 April 2009
<b>Unitised with-profits pension funds:</b>		
WP2	2.00%	1.00%
DAF	4.00%	3.00%
DA2	nil	nil
<b>Unitised with-profits pension deposit administration funds:</b>		
SE Funding (premium paying)	7.60%	nil
SE Funding (paid-up)	6.85%	nil
Barclays Retirement Accumulator Plan	6.60%	nil
Money Plus (accumulation units)	6.60%	nil
Money Plus (initial units)	4.10%	nil
Money Purchase Plan (accumulation units)	7.60%	nil
Money Purchase Plan (initial units)	5.60%	nil
<b>Unitised with-profits life funds:</b>		
WPB (1.0% annual management charge)	nil	nil
WPB (1.5% annual management charge)	nil	nil

Yearly bonus declared in arrears	31 December 2010	31 December 2009
<b>Traditional with-profits:</b>		
Life	1.50%	1.50%
Pensions	0.25%	0.25%
<b>Unitised with-profits:</b>		
Pensions WPE fund	Nil	Nil
Pensions WP1 fund	Nil	Nil
Pensions Reflex Deposit Administration fund	Nil	Nil
Life WPC fund	Nil	Nil
Life WWP fund	Nil	Nil

Yearly bonus rates are in addition to any guaranteed growth rates, which are as follows:

Fund	Guaranteed growth rate each year
Traditional with-profits	In the range 2-5.5%
Unitised Pensions WPE	Around 5.5%
Unitised Pensions WP1	4.0%
Unitised Pensions WP2 and DAF, Unitised Life WPB	0.0% (in other words the unit price can't fall)
Unitised Pensions DA2	3.0%
Unitised Pensions Reflex Deposit Administration	5.0%
Unitised Pensions Deposit Administration (other)	0.0% (in other words the accumulated fund can't fall)
Unitised Life WPC	3.9%
Unitised Life WWP	2.7%
All new generation with-profits funds	No guarantees

Guaranteed growth rates may only apply if you stay invested to a date specified in your policy documents (for example a specified maturity or retirement date or on earlier death).

Increases in yearly bonus rates were seen in certain funds in 2010 consistent with favourable market conditions, although rates in other funds remained at zero (or very low levels). It's important to view this in the context of the additions and guarantees over the whole investment term. We have to make sure that guarantees to our investors can be met. Once a yearly bonus is added to an investment, it increases the guarantees under that investment. If we build up guarantee levels that are too high, our financial position may be adversely affected and this may mean changes in investment mix and in payouts to investors.

This is particularly relevant at the moment because of the following:

- Many with-profits funds have high rates of future guaranteed growth on top of any yearly bonus additions (see the table on guaranteed growth rates on the previous page).
- Guaranteed benefits continue to remain high relative to asset shares under a number of funds.
- We expect future investment returns to be relatively low, consistent with an expected long-term low inflationary environment.

Because of all these factors, we believe the 2010 yearly bonus declaration represents a sensible strategy to protect the long-term interests of all with-profits investors.

Guaranteed benefits and yearly bonuses represent only a part of the ultimate payout under a with-profits investment. There are also final bonuses and market value reductions (MVRs) under unitised with-profits funds and final bonuses and surrender value bases under traditional with-profits contracts. We amended final bonus rates and MVRs every three months during 2010. All our final bonus and MVR calculations in 2010 were in line with the PPFM.

### Deductions for guarantee costs and estate distribution

The PPFM states that we intend to make a regular deduction from asset shares to meet some of the expected future guarantee costs, including guaranteed annuity option costs. The rest of the expected future guarantee costs will be met from the estate.

The PPFM also states that we expect to make a regular addition to asset shares from the estate, although this isn't guaranteed.

The same rate of deduction for guarantee costs and addition from the estate applies to all our with-profits contracts except for new generation with-profits funds, where we make no such deductions or additions. This is consistent with the PPFM.

During 2010 we made monthly deductions for guarantee costs equivalent to 0.5% a year from asset share investment returns. Also, we enhanced the asset shares of those contracts in force at 31 December 2010 by 1.50%, resulting in a net asset share enhancement over 2010 of 1.00%.

### Calculation of surrender values (traditional with-profits)

During 2010 we checked that the surrender values of traditional with-profits contracts were consistent with asset shares, which they were. As a result, no changes were made to the underlying bases.

### New generation with-profits: expected growth rates

We reviewed the yearly expected growth rates (EGRs) for the new generation with-profits funds during 2010 against our expected future rates of return on equities and fixed interest securities. As a result, the yearly EGRs applying during 2010 were:

	From 1 January 2010 – 31 December 2010
Life Growth	7%
Life Cautious	6%
Pensions Growth (including Stakeholder)	8%
Pensions Cautious (including Stakeholder)	7%

The EGRs are before annual management charge deductions.

### New generation with-profits: smoothing adjustments

In line with the PPFM, we currently don't apply smoothing adjustments to payouts to investors leaving the new generation with-profits funds as long as the ratio of the smoothed fund value to the actual value of the backing investments is in the range 80% to 130%. During 2010, there were no claims under investments where the ratio was outside this range, so we didn't apply any smoothing adjustments.

# Changes to the PPFM during 2010

We made a minor change to the PPFM in 2010 (effective from 1 January 2011). This change clarified that short-term market fluctuations could lead to target equity ranges being temporarily breached and, if so, that positions would be corrected as soon as possible.

Some minor changes were also made to the customer-friendly versions of the PPFM. These changes highlighted the degree of discretion held by the directors of Scottish Equitable plc in the running of the with-profits business and emphasised that it's not always the case that yearly bonuses will be granted.

# Our directors' opinion on our with-profits management in 2010

We can confirm that, throughout 2010, we have met the requirements of the PPFM and we have exercised our judgement fairly, taking into account the interests of with-profits investors in a fair and reasonable manner. Our governance arrangements involve Scottish Equitable Policyholders Trust Ltd providing some independent judgement in the assessment of our compliance with the PPFM. We continue to be satisfied with the operation of these arrangements (and the judgement exercised) throughout 2010.

**The directors of Scottish Equitable plc**  
**March 2011**

We're not allowed to give you advice, but if you'd like any further information on our with-profits contracts or funds and how we run them, please contact us:

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Edinburgh Park  
Edinburgh  
EH12 9SE

08702 42 67 89

# Statement by the With-Profits Actuary

I can confirm that, in my opinion, the firm's 2010 annual report to with-profits investors and the discretion exercised by the firm's directors during 2010 have taken the interests of with-profits investors into account in a reasonable and proportionate manner. In reaching this conclusion, I have taken account of the information and explanations provided to me by the firm, as well as the relevant rules and guidance of the Financial Services Authority, the Board for Actuarial Standards and the Actuarial Profession.

**Craig Murison**  
With-Profits Actuary  
Scottish Equitable plc  
March 2011



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