Report to Clerical Medical
UK With-Profits Policyholders

Report on Principles and Practices of Financial Management (PPFM) for 2019
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This annual report tells you how we have managed the Clerical Medical With-Profits Fund in 2019. It explains how we have used our discretion in managing the Fund, and gives information about the Fund’s investments and the returns the Fund has earned from them.

Your policy is invested in the Clerical Medical With-Profits Fund, held within Scottish Widows Limited.

All the different types of Clerical Medical with-profits policies sold in the UK, Europe and other overseas markets are supported by the same Clerical Medical With Profits Fund.

We have managed the With Profits Fund in line with our published principles and practices – our PPFM. The PPFM focuses in detail on the standards, methods and controls we use to ensure we run with-profits fairly. It also explains how we respond to changes in the economic environment.

You may find it helpful to refer to the ‘With-profits summary’ which summarises how we manage with-profits policies. This document can sometimes also be referred to as the ‘CF PPFM’ (customer friendly PPFM). The current version is also available on our website www.clericalmedical.co.uk

If you have any further questions please contact us on 0345 788 3333.

The Board of Scottish Widows Limited met on 19 March 2020 to consider the matters covered in this report including the statement provided by the With-Profits Actuary appended at the end of the report, and advice from the independent With-Profits Committee that it has reviewed the report and considers it appropriate for the Board to publish it. The Directors are satisfied that the Clerical Medical With Profits Fund has been managed in accordance with the PPFM in all material respects with all identified errors being corrected.

1. Our Aim

Our aim is to achieve fairness between different types and groups of with-profits policyholders, and between them and our shareholders. We believe fairness is achieved:

- By making sure that, when guaranteed minimum payments apply, we pay at least those amounts to policyholders.
- By aiming to pay out a fair share of investment performance to with-profits policyholders (or any guaranteed amount, if higher).
- By aiming to achieve growth over the long term by investing a significant proportion of the Fund in higher-risk assets such as company shares and property, whilst ensuring that we can meet the With-Profits Fund’s guarantees.
- By aiming to smooth through some of the peaks and troughs of stock market values.
- By adding regular bonus. We have to bear in mind that, where guarantees apply, we cannot take away regular bonuses once we have added them to your investment. This means that we set the rate lower than we otherwise might do, and that we may set regular bonus rates at zero.
- By moderating the pace of estate distribution to strike a balance between enhancing payouts for eligible policies and safeguarding the security of remaining policy benefits.

2. The Clerical Medical With Profits Fund in 2019

2.1 Investment returns over 2019

After a challenging 2018, most investment markets recovered to end 2019 with robust gains. Investor sentiment improved early in the year, when the US Federal Reserve announced an abrupt turn-around in policy, announcing three interest rate cuts for the year, instead of the expected three increases. Markets were also supported towards the end of the year by the prospect of a US/China trade deal. In the UK, the FTSE All-Share Index appended at the end of the report, and advice from the independent With-Profits Committee that it has reviewed the report and considers it appropriate for the Board to publish it. The Directors are satisfied that the Clerical Medical With Profits Fund has been managed in accordance with the PPFM in all material respects with all identified errors being corrected.

The Directors of Scottish Widows Limited
19 March 2020

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Absolute return funds (which aim to deliver positive returns in most market conditions) generally had small gains but underperformed most other asset classes.

Against this background, the Clerical Medical With Profits Fund produced an overall investment return on assets backing policies of 10.8% in 2019.

2.2 Investment policy

Rather than have one investment strategy for the whole of the Clerical Medical With Profits Fund, different parts of the Fund follow different strategies.

- **Asset shares** are the amounts resulting from the investment of premiums, less deductions such as policy charges. They represent a fair share of the Fund for the policies to which they relate. A significant proportion of the assets that support the asset shares has historically been invested in higher risk assets, such as company shares and property, which have the potential for higher returns and therefore growth. Different investment mixes apply for the asset shares of UK policies and different classes of international policies.

- The remainder of the Fund is known as the ‘estate’, which is held as a cushion to support payouts in adverse conditions such as a fall in stock market values. Since 2010, part of the estate has been distributed to set higher amounts of final bonus than would otherwise apply. The estate, including the part being used to improve final bonuses, follows a more cautious investment strategy such as holding cash deposits or government bonds.

The Board reviews the strategic investment mix regularly. For asset shares, we choose the mix of assets with the aim of:

- getting the best long-term performance; and
- making sure that the Clerical Medical With Profits Fund can always meet its guarantees (also taking account of the assets in the estate).

In 2019, we applied the following asset allocation changes:

- Moved a portion of the fund’s equity exposure from other developed regions to the UK between September and December.
- Removed the remaining derivatives that were put in place to mitigate a portion of the equity downside risk. These were removed at the beginning of December.
- Addition of private debt and emerging market debt as part of the strategic asset allocation.

We allow our investment managers to apply tactical asset allocation decisions to vary, within given parameters, the strategic mix selected by the Board, based on their view of how different types of asset and regions will perform in the shorter-term.

The mix of investments backing asset shares of UK policies is shown below. The changes over the year reflect the combined effect of:

- The strategy changes described above.
- Changes in the shorter-term positioning taken by our investment managers.
- Relative market movements (e.g. a strongly performing asset will increase as a proportion of the fund relative to assets which don’t perform so strongly).

<table>
<thead>
<tr>
<th>Asset Allocation</th>
<th>31-Dec-17</th>
<th>31-Dec-18</th>
<th>31-Dec-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• UK government bonds</td>
<td>4%</td>
<td>8%</td>
<td>4%</td>
</tr>
<tr>
<td>• Corporate bonds</td>
<td>10%</td>
<td>10%</td>
<td>11%</td>
</tr>
<tr>
<td>Loans secured against property</td>
<td>3%</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td>Property</td>
<td>13%</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>Equity shares</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• UK shares</td>
<td>18%</td>
<td>19%</td>
<td>20%</td>
</tr>
<tr>
<td>• Non-UK shares</td>
<td>26%</td>
<td>23%</td>
<td>22%</td>
</tr>
<tr>
<td>Absolute Return funds*</td>
<td>14%</td>
<td>15%</td>
<td>13%</td>
</tr>
<tr>
<td>Emerging Market Debt</td>
<td>0%</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>Private Debt</td>
<td>0%</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>Other investments**</td>
<td>12%</td>
<td>7%</td>
<td>6%</td>
</tr>
</tbody>
</table>

* Absolute Return funds aim to make a positive return in most market conditions.

** The main other investments are cash deposits.

Some pension policies contain valuable options to convert the payout from the policy into a pension at guaranteed terms. The cost to the Clerical Medical With Profits Fund of honouring these options is affected by market interest rates and equity levels.

To protect the fund from changes in market interest rates the fund holds specially constructed investments, commonly referred to as “hedges”. These investments rise and fall in value to a similar extent that the options rise and fall as market interest rates change. We hold this hedge to protect the financial stability of the fund against downward movements in interest rates. This enables the fund to enjoy greater investment freedom, which ultimately improves the expected return to our policyholders.
We also hedge against equity market risk. This helps to protect the fund against a reduction in the value of global equity markets.

These investments are held separately, in the estate, and are not included in the assets shown in the table above.

For detailed, up-to-date information on where the Fund is invested please refer to our “With-profits investment factsheet”. This is available from your financial adviser or on our website www.clericalmedical.co.uk

2.3 Regular bonuses

The size of the regular bonus depends mainly on what bonuses we have already added, on past investment performance and on what we expect in the future.

We have to bear in mind that, where guarantees apply, we cannot take away regular bonuses once we have added them to your investment. This means that we may set the rate lower than we otherwise might do, and we may set regular bonus rates at zero. If we were to set rates of regular bonus at higher levels, we’d restrict our investment freedom and have to invest more of the With-Profits Fund in more predictable lower-risk assets (such as cash or government bonds). Changing the Fund’s assets in this way would mean we would expect to achieve a lower total return on your investment over the long term, even though the guaranteed part of the return on your investments that comes from regular bonuses might be higher.

In most cases regular bonus rates did not change in 2019 compared to 2018 and remain low in absolute terms in line with the approach described above. Regular bonus is only part of a policy’s payout and final bonus may be added whether or not we are currently adding regular bonus to a policy (please see section 2.4).

2.4 Payouts in 2019 – final bonuses and market value reductions

Normally, we will not have passed on the full investment returns earned over policies’ lifetimes as regular bonus. We therefore use final bonuses to ‘top up’ payouts to policyholders who will also benefit from the rest of those investment returns.

For unitised policies, if you come to take money out of the Clerical Medical With Profits Fund when a guarantee doesn’t apply, we may need to make a reduction called a market value reduction (MVR). An MVR would only apply if the value of your units is higher than your fair share (the asset share as explained in section 2.2). The MVR would have the effect of ensuring that the amount paid out was more in line with your fair share.

Final bonus rates and MVR rates depend on when the investment was made. This helps ensure that performance is shared fairly between policies starting at different times, as the investments will have experienced different returns over the policy lifetimes.

Our final bonus rates and MVR rates have been kept under review, and have been changed in line with our published policy. We normally carry out reviews every six months, and did so at 1 February 2019 and 1 August 2019. As a result of the February review payouts reduced by approximately 1.5% for the majority of policies while as a result of the August review payouts increased by approximately 2.5% for the majority of policies. This reflected market movements offset slightly by the application of smoothing, and an increase in the level of distribution of excess estate (please see below).

Distribution of excess estate

At least once per year, we determine whether the estate is more than is needed to meet the aims of the prudent management of the Clerical Medical With-Profits Fund. A distribution of excess estate began on 1 February 2010 by adding an extra amount within the bonuses when policies pay out.

We currently review the level of the estate against what is needed every six months. There may be times when we can increase the extra amount included in any final bonus due, but there may be times when we have to reduce it or possibly not pay anything extra at all. At the reviews in 2019 an increase was made in both February and August, and the distribution is now adding around 7% to payouts for fully eligible policies. You can check the extent to which your policy is eligible by looking at page 10 in the “With-profits summary” document.

For eligible policies, we are currently planning to add to the distribution at a rate of 0.5% of asset share each year, though this is not guaranteed.

Smoothing

Investment markets go up and down daily and can move a lot in a short space of time. A with-profits investment has a special feature called ‘smoothing’. The effect of smoothing is to keep back some of the gains earned in good investment years and use them to help pay bonuses in poor investment years and vice versa.

To achieve this smoothing effect we look at investment returns your policy would have earned if it had started and finished up to two years earlier and up to two years later. When investment conditions experienced over the actual term of your policy are better than those experienced over these other terms, we keep back some of the returns when deciding on the final bonuses (which we normally do twice per year). When they have been less than those experienced over these other terms, we add to the returns when deciding the final bonuses.

To support our aim that the Clerical Medical With Profits Fund continues to be well equipped to react to a range of investment conditions, we aim to ensure that the impact of smoothing does not affect the estate. We make an adjustment that spreads the impact of smoothing over the asset shares of all the policies in the Fund. This adjustment is currently calculated every six months. The adjustments resulting from these reviews in 2019 had the result that asset shares were increased by 0.1% on 1 August 2019.
Guarantee Costs
We guarantee a minimum payment from your policy upon the occurrence of specific events. This guarantee is described in your policy documents. We currently make a deduction each year from the assets underlying with-profits policies to cover the cost of meeting those guarantees. We regularly monitor the level of deductions to make sure that it is fair for each group of policyholders and, as a result, currently deduct less for premiums that were paid after 1 January 2008 than for premiums paid before 1 January 2008.

We plan to deduct no more than 1% in any one year, but in very adverse market conditions we may have to deduct more than this to ensure that guarantees are met across the Clerical Medical With-Profits Fund. The deduction applied in 2019 was 0.67% of asset share for premiums paid before 1 January 2008, and 0.22% for later premiums.

Some older policies, where a deduction has already been made, and certain policies sold between January 2003 and September 2004, are not subject to this deduction. This is in line with our published policy.

Target Ranges
The asset shares of specimen policies help us decide on the levels of final bonus and the payouts made when policies are surrendered. As stated in the ‘With-Profits Summary’, the amount that payouts fall within a specified range around asset shares for these specimen policies (ignoring distributions from the estate – please see section above titled ‘Distribution of excess estate’). These ranges describe the maximum expected variation between the payout and asset share of a specimen policy. In practice the majority of payouts are clustered around 100% of asset share.

Based on representative specimen policies we regularly analyse the extent to which payouts may be different from asset shares for reasons other than the smoothing of investment returns (i.e. due to the way in which policies are grouped and specimen policies are chosen). We separately monitor, at least weekly, the extent to which changes in investment markets cause asset shares to move relative to payouts. By combining the results of those investigations and monitoring, we are able to identify if payouts might be moving outside of the target ranges.

During 2019 the majority of payouts on specimen policies were within the target range.

2.5 Administration costs
For all unithed business sold since 1996 there are no deductions for administration costs on policies other than the policy charges and the costs relating to buying, selling and holding assets. The policy charges are made in line with the terms of your policy.

For non-unithed business there are no stated charges. Instead, we deduct an amount to cover the expenses of administering these policies when we are calculating bonuses. We review the level each year to reflect our actual expenses on this block of business, and periodically check that the deductions are not out of line with comparable charges made by other companies. One of these periodic checks was carried out in 2019 and confirmed that our charges are in line with other companies’ charges. The charges have been agreed by the Board on the advice of the With-Profits Actuary and are considered to be properly attributable to the Fund and to be fair and equitable.

2.6 With-profits policies issued to new customers
There are currently a small number of with-profits annuities arising out of Euro denominated pension products sold into Germany and Austria. While this business is no longer sold the amount of with-profits annuities in the Clerical Medical With-Profits Fund will increase in future years as policyholders who invested in the aforementioned pension products reach retirement age in increasing numbers.

More generally, there has been a reduction in demand for with-profits policies in the insurance market. As a result, we are no longer actively seeking new with-profits business. The number of policies within all other product classes is therefore reducing as existing life policies reach maturity; pension customers reach retirement and other withdrawals are made.

This does not change the prospects for our current with-profits customers or the protection offered by policies’ guarantees and options. With-profits policyholders can expect to continue to benefit from a diversified investment policy and from the smoothing of returns (section 2.4 explains smoothing).

2.7 The role of the With-Profits Committee
We have an independent With-Profits Committee. It reviews how the Clerical Medical With-Profits Fund is managed and scrutinises any major proposal that affects the Fund. It provides advice directly to the Board. An important responsibility of the Committee is to assess whether the interests of different groups of with-profits policyholders, other policyholders and shareholders have been properly addressed, and whether customers have been treated fairly. The Committee is provided with a variety of reports and information to enable it to carry out these assessments.

At the start of 2019, the Committee comprised three members, none of whom have any management or executive role with the company (or our parent company, Lloyds Banking Group) and one of whom is a non-executive director of the company. Two additional members joined the Committee over 2019 one of whom is a non-executive director of the company. The terms of reference set out the responsibilities of the Committee, and can be found at: http://reference.clericalmedical.co.uk/docs/E2088.pdf
2.8 How we ensure customers are treated fairly and in line with our Principles and Practices

There are five main controls in place to ensure this:

- The scrutiny provided by our With-Profits Committee, which is described above in section 2.7.
- Whenever we make important changes that affect the way we manage our with-profits policies, our With-Profits Actuary, who advises the Board, presents a report for the directors giving the reasons behind the proposals and how these comply with the PPFM.
- Throughout the year, all the data, work and actions that supported our decisions were recorded. The With-Profits Actuary has reviewed this evidence and is satisfied that the decisions were consistent with the PPFM, the Financial Conduct Authority (FCA) rules on Treating With-Profits Customers Fairly and the court-approved Scheme that governs the operation of the Clerical Medical With Profits Fund in all material respects. He has stated that, in his opinion, the interests of policyholders have been taken into account in a fair and balanced way.
- The With-Profits Actuary has reported on this evidence to our With-Profits Committee, covering the areas where decisions were made, and how they complied with the PPFM and with the rules of the Financial Conduct Authority relating to the fair treatment of with-profits customers.
- The With-Profits Committee also receives reports from our internal audit function, which reviews various aspects of our business and controls. Input from an independent actuary is also sought when appropriate.

Further information on with-profits:

We’ve produced a number of documents on our With-Profits Fund which you may find useful. These are:

- Principles and Practices of Financial Management (‘PPFM’)
- With-profits summary (a document which can sometimes also be referred to as a ‘CF PPFM’ or customer-friendly PPFM).
- With-profits investment factsheet.

You’ll find copies of these documents and the latest information on bonus rates and MVRs on our website www.clericalmedical.co.uk

Statement from the With-Profits Actuary

In my opinion, the discretion exercised by Scottish Widows Limited during 2019, and the report from the directors to which this statement is attached, have taken the interests of Clerical Medical with-profits policyholders into account in a fair and balanced way. I base this opinion on the information and explanations provided to me by the company, including information requested by me, and the relevant rules and guidance issued by the Financial Conduct Authority.

Alasdair Smith
Fellow of the Institute and Faculty of Actuaries
With-Profits Actuary
19 March 2020