

An independent report  
for 2004 prepared for  
Scottish Provident  
policyholders by the  
Supervisory Committee

## Introduction

This is a report to Scottish Provident With Profits policyholders from the independent Supervisory Committee which has responsibility for your funds.

When the Scottish Provident Institution demutualised in 2001 it became part of the Abbey National group as a new company, Scottish Provident Limited ('the Company'). At the same time, a Supervisory Committee was set up to look after the interests of the With Profits policyholders. It decides on the investments and bonuses of the With Profit Fund (the 'Fund') and within it the Special Fund. The Special Fund contains the policies originally underwritten by Provincial Life that transferred to Scottish Provident when it acquired that business. The Committee also has to make sure that the Fund is run in the way that the scheme of demutualisation requires.

The Committee is independent of Scottish Provident Limited and of the Abbey Group, but it works closely with the management and with the Actuary who has special responsibility for the With Profits Fund. Since it was set up the Committee has met most months to do this. Details of the Committee members are at the end of this report.

From next year, all companies with funds like this will be obliged to send a report to policyholders. But the Committee and the Company wanted to send a report now to keep you fully informed about changes to the Fund. Future reports will be published on the Company's website unless there is a need to send them directly to you.

## Purpose of this report

This report tells you about a number of important things which have affected the With Profits Fund in 2004. There were changes in the regulations that applied to the Fund, and so in how it was managed.

In addition to this report, the Company has produced quite a lengthy document about how it aims to manage the Fund. This is called the Principles and Practices of Financial Management. This is quite long (over 40 pages) and technical. This document is on the Company's website and a copy is available if you ask for one. Next year the Company will send you a summary of it.

This report will cover:

- > Changes to the rules governing With Profits funds in 2004
- > What has been done to comply with the new FSA rules
- > How the Fund has been protected
- > Changes to smoothing practice
- > Treatment of annual and final bonuses
- > How surrender values are determined
- > Expense charges and taxation
- > Supervisory Committee Member details
- > How you can find out more

This report is provided for general information only and is heavily summarised and simplified. It concerns the management of your policy in 2004 only.

For fuller, more up-to-date information about how your policy is managed, please see the most recent version of our Principles and Practices of Financial Management, available on our website, or by post on request (see the end of this report for contact information).

## What is a With Profits fund?

A With Profits fund is an investment fund where the profits are shared among investors, or policyholders. Policyholders do not directly own assets or a portion of the Fund, but instead are allocated payouts that represent a fair share of the Fund's overall value, taking all relevant factors into account. Sharing in the profits means you also share the investment risks in the Fund. Your policy may provide some guarantees and these can be of value to you, but the cost of guarantees for other policyholders can reduce the profits available for distribution. Certain groups of policy will also share in other profits and losses in the Fund. In the Company there are two main types of policy that receive a share of the profits:

- > The older, traditional policies (often called 'conventional With Profits') where premiums secure assured benefits;
- > The newer plans (sometimes called 'unitised With Profits') where premiums buy units in the Fund.

## Why was 2004 significant?

2004 was a significant year for the Fund because it had to comply with new regulations made by the Financial Services Authority. These regulations apply to all With Profits funds, but affect each differently. They make changes to how the Fund is to be managed and governed. The Company has done a great deal of detailed work to apply the new rules to the Fund. The Supervisory Committee has worked with them to ensure the changes that were needed are fair and in the best interest of policyholders.

Throughout 2004 the Committee has relied upon the advice of Donald Ramsay, who was SPL's Appointed Actuary and is now the With Profits Actuary. Under the regulations, he must take account of the interests of policyholders.

## What changes have been made to the way the Fund is governed?

All companies with With Profits funds now need to publish details about how their fund is managed in a document called the Principles and Practices of Financial Management, or PPFM.

Future Company reports to policyholders will concentrate on how well the running of the Fund has matched up to the PPFM during the year.

The new FSA rules require companies which have With Profits funds to arrange for independent oversight in the interests of the policyholders. This can be done by having what is called a With Profits Committee. The Supervisory Committee will do this for your Fund and, as a With Profits Committee, will be required to ensure that the Fund is operated consistently with its Principles and Practices of Financial Management.

## Complying with the new regulations

The new FSA rules state that there must be enough money in each fund (or sub-fund) in a company to make 'full and fair' payments to policyholders when their policies mature. The Company has to take a prudent view of the future when it decides how much is 'enough' and be prepared for the possibility that the reality may be even worse! It also has to make sure it has enough money to meet any guarantees to policyholders.

During 2004 we closely reviewed the Fund's performance and outlook. We wanted to know if there was enough money in the Fund to meet the Company's obligations to policyholders in the future. We concluded that there was not enough, that is to say, the Fund had a small deficit following these new rules.

## Why was there a deficit?

This happened for a number of reasons. Share values had been falling since 1999 and interest rates had been steadily coming down since the mid-1990s, good news for borrowers but not for savers. Furthermore, we're all

living longer on average – more good news, except that it means pension funds have to go further than they used to. This made the cost of providing pensions from the Fund greater than it used to be.

Finally, the new FSA rules require that the cost of any guarantees made to policyholders be included in the Fund's liabilities, which means that money must be set aside within the Fund.

All of these factors combined to turn what was a surplus of assets under the regulatory rules in force at the time Abbey acquired the Scottish Provident business to a small deficit in 2004 under the new rules.

So, what did the Company do about this deficit?

## How the company has covered the deficit

The Company took legal and actuarial advice in determining the options available and in selecting the fairest course of action for all policyholders. The Committee reviewed this advice and we were satisfied that the proposed changes in the Fund were consistent with this advice.

The changes involved a small reduction (1%) in payouts, apart from guaranteed benefits.

## Adding a safety margin

The new FSA rules also mean the Company has to have, in effect, a safety margin in case circumstances turn out to be worse than has been planned for. To decide how big this should be, the Company tested how the Fund might behave in different circumstances, including very unfavourable conditions. This work led us to conclude that £125 million would be enough in all but the very worst circumstances. This safety margin is not part of the Fund, but the Company has provided additional funds which can be called upon if needed. A description of how this money will be used if needed is in the PPFM, which you can view on the Company's website.

## Protecting our policyholders in the Fund

We mentioned testing how the Fund would behave in different situations, including adverse conditions. Among the most likely of these is variable investment markets. Share values can go up and down and sometimes, in difficult economic conditions, they can remain depressed for some time, which is what happened in the early years of this decade. Changes in interest rates can also have an effect on the Fund's performance.

To protect the Fund against these movements, the Committee agreed that the Company should purchase assets specifically designed to help meet the guarantees that policyholders have. We call these the 'Fund protection assets'. More than £300 million was spent on these assets. Many of these are complex financial instruments whose value is affected by movements in well-known stock market indices such as the FTSE 100 Index. We can further reduce risk in the Fund by using some of the other assets to track these same stock market indices. The Company is currently reducing risk in this way. The management of these 'Fund protection assets' will be monitored closely by the Committee in the future.

In deciding which assets should be purchased to protect the Fund in this way, the Committee considered a substantial amount of external professional advice and we are satisfied that the protection should be effective within reasonable tolerances. We are also satisfied that these assets were purchased at fair value. This is important because they were purchased from another company in the Abbey group.

## What if the protection is not needed?

We hope that the Fund won't have to call on this protection. It is there to look after the Fund's policyholders, but if the protection is not needed, then a large proportion of the Fund protection assets can be cashed in. Should the future turn out exactly as expected over a given period, around two-thirds of this asset (around £200 million) can be cashed in. If economic conditions are better than expected over a given period, it should be possible to reduce the amount of protection the Fund needs and cash in some of the protection assets. They can then be invested to provide returns to the Fund.

## Why might this happen?

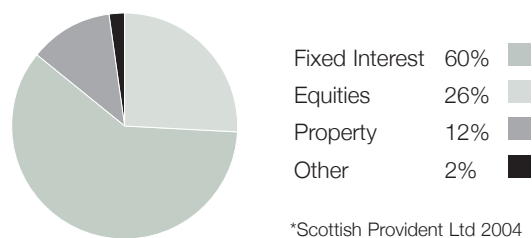
There are several reasons why all the Fund protection assets that were purchased might not be necessary:

- > Returns on investments may be as good as or better over a given period than it was thought they'd be when buying the Fund protection assets for that period;
- > Policyholders, in the decisions they take, may make the liabilities of the Fund less expensive than was assumed in 2004, for example they may surrender policies and not invoke their guarantees;
- > If investment markets become more stable in future and don't fluctuate like they have done in recent years less protection may be needed than was assumed.

## Your Fund's investments

In considering the package of measures to bring in as a response to the new FSA rules, we looked at the Fund protection assets in the Fund and the available safety margin outside the Fund. In the light of this we decided to raise the proportion of the Fund which is invested in shares to a target level of 35%, to ensure the Fund can aim to deliver satisfactory returns for policyholders.

At the end of 2004 the split of assets in the Fund, excluding the protection assets, was:



In 2004, the Committee agreed with the Company's proposal to contract out the management of the Fund to third party fund managers. The fund managers will primarily track agreed investment indices.

The investment returns achieved by the Fund mean that the assets which back policies have grown during the year. For SPI UK policies, the rate of growth has been 10%, and for SPI Republic of Ireland policies by 11%. These are the rates of return before taxes and charges. The investment returns for the Special Fund mean that the assets backing policies grew by 6% in 2004 (before taxes and charges).

## Balancing assets and liabilities

The FSA's new rules required us to keep a balance between the total value of assets in the Fund and the 'liabilities' – principally the policy benefits to be paid to policyholders in future. To maintain this balance we have made some changes to our 'smoothing' practice. 'Smoothing' is the way With Profits funds try to protect policyholders from the direct impact of ups and downs in asset values. While no-one objects to the 'ups', many people don't want to take the risk of the 'downs'. The revised approach to smoothing ensures that policyholders receive what is calculated to be their fair share of what the Fund's assets are worth at the time they leave it.

As a result, the changes we made to our smoothing practice mean that there was a reduction in the year-end bonus declaration for the Fund implemented in March 2004. A further adjustment, this time an increase, was made in July 2004 (these changes did not affect the Special Fund). We now think payouts are generally close to fair shares of the asset values for maturing policies.

## Annual and Final Bonus rates

The payout on your policy is worked out using a combination of annual bonuses and final bonuses. During 2004 we did not declare any annual bonuses: we could not do that while the Fund had little or no surplus (the exceptions to this were some of the oldest With Profits units where the Company had guaranteed there would always be at least a minimum level of bonus). But your policy continued to benefit from the growth in the Fund and our aim is to reflect that fairly in the final bonus and the payment you receive when your policy comes to an end.

In order to make sure any surplus amounts which do emerge in the Fund in the immediate future are distributed fairly, we intend to use them in two ways:

- > Declaring final bonuses payable only when a policy leaves the Fund;
- > And/or reducing market value reductions which are charged if With Profits units are cashed in early.

We will do this rather than declare new annual bonuses. We currently expect to follow this approach until we think there are enough surplus assets in the Fund to let us add annual bonuses without putting at risk:

- > The payment of final bonuses on maturing policies; or
- > The level of surrender values on policies which do not run their full course.

Looking realistically at the liabilities of the Fund (what the Company will have to pay out in future), the Company estimated that at the end of 2004 there were surplus assets in the main Scottish Provident With Profits Fund of 2% of Fund value. We could deal with this in a number of ways:

- > Carry it forward to next year;
- > Increase the level of payouts to policyholders; or
- > Increase the percentage of the Fund invested in shares.

The Committee has decided to give priority to improving the level of payouts made to policyholders, given the reduction to payouts we had to make during 2004. At the end of 2004, the Special Fund had a surplus of 20% of Fund value. The Company aims to distribute any such surplus fairly to Special Fund policyholders over the remaining life of that Fund.

## How surrender values are determined

### Unitised With Profits

Surrender values for With Profits units are set by adding a final bonus to the face value of units or charging a market value reduction on them, depending on economic circumstances. The final bonus/market value reduction is calculated by comparing the face value of units with the fair share of assets available in the Fund. Payouts are set to ensure every policyholder receives their fair share of assets, calculated at the time they surrender.

### Conventional With Profits

Conventional With Profits surrender values are currently set by adjusting the expected value of maturity benefits to allow for non-payment of future premiums. An allowance for final bonus may be included if the current value of future payouts is less than the fair share of assets within the Fund corresponding to that policy. Payouts are set to reflect a fair share of assets.

## Expense Charges and Tax

### Expenses

During 2004, expense charges made on the Fund have continued to be as set out in the Scottish Provident scheme of demutualisation. This scale of charges will apply until 2011. The 'capped' level of expenses in 2004 was £17.4 million.

This compares to a best estimate of the actual cost of administering the With Profits policies of £18.4 million. The £1million cost overrun was paid by the shareholder.

## **Taxation**

The Fund has continued to be charged tax as if the Fund represented all of the assets and liabilities of a mutual life insurance company. This also complies with the requirements of the Scottish Provident scheme of demutualisation.

## **New business plans and premium rates**

The Fund no longer accepts new policies. However, some existing With Profits policies have the right to increase the size of the policy by adding 'increments'. The terms of such 'increments' have been set so that they do not damage the interests of other policyholders within the Fund and we will aim to set fair payouts for these increments when they mature.

## **Communicating with policyholders**

The Committee reviewed the 2003 year-end bonus mailing, which was issued during April and May 2004. This included some changes in scales of final bonuses and market value reductions which were introduced as interim measures as part of the Fund Review project outlined in this report.

## **Treating customers fairly**

The With Profits Fund contains a great variety of policies and types of policy benefits. This makes it important to ensure that we treat different groups of policyholders with equal consideration. We also strive to maintain fairness between policies which mature or are surrendered and leave the Fund on the one hand and policies which remain in the Fund on the other.

## **Treatment of early surrenders**

For policies which are surrendered before they are due to mature, care has been taken to ensure as much as possible that any 'surrender value' paid out is not greater than the fair value of the assets which back these policies.

## **Treatment of retirements**

When pension policyholders retire, an amount of money is paid out of the Fund in order to buy the annual amount of pension which is due to be paid. Again, consistent with the Scottish Provident scheme of demutualisation, the amount of money represents a realistic estimate of the actual cost of the pension benefits in question.

For pension policies with guaranteed annuity options where the policyholder has chosen to retire during the year, the guaranteed annuity rate has been applied to the fair value of the assets. This practice is in line with the PPFM and the legal advice received by Scottish Provident.

## **Treatment of policies remaining in the Fund**

Policies which remain in the Fund will continue to benefit from the returns achieved by the Fund. Our aim is to ensure that policyholders' payouts reflect their fair share of the assets of the Fund at the time they leave it.

J D Gallagher  
Chairman  
Supervisory Committee  
September 2005

## Supervisory Committee Members

### James Gallagher

Jim is a senior civil servant, who is presently a visiting Professor of Government in the University of Glasgow. Before that he was Head of the Scottish Executive Justice Department and he has been a member of the Prime Minister's Policy Unit in Downing Street, and Deputy Head of the UK Cabinet Secretariat. He is visiting Professor in Public and Corporate Ethics at Glasgow Caledonian University. Jim was a director of Scottish Provident Ltd and of Scottish Mutual Assurance plc. He became a member of the Supervisory Committee when it was created in 2001 and succeeded Allan Denholm as Chairman of this forum in 2004.

### Mark Boleat

Mark is a former Director General of the Association of British Insurers and currently holds a portfolio of positions including company directorships and membership of the Gibraltar Financial Services Commission and the National Consumer Council. He is also a former director of SPI and Scottish Mutual. He became a member of the Supervisory Committee when it was created in 2001.

### Allan Denholm

Allan is a Past President of The Institute of Chartered Accountants of Scotland and a Trustee of a number of Pension Funds and charitable bodies. He is a General Commissioner of Income Tax. He has a long association with Scottish Mutual spanning 30 years. He has served as a director of The Scottish Mutual Assurance Society, Scottish Mutual Assurance plc and Abbey National Life plc. He became Chairman of the Supervisory Committee when it was created in 2001.

### Tony Fine

Tony qualified as a Fellow of the Institute of Actuaries in 1968 and has many years' experience as a consulting actuary. He was appointed as the Independent Member of the Supervisory Committee in February 2004. The Scottish Provident Demutualisation Scheme states that the Committee must have one Independent Member who is not and has not been employed in an executive capacity by, and does not hold and has not held any other office with, any company at any time when it is or was a member of the Abbey Group.

### John Foden

The majority of John's career was spent with PA Consulting Group where he was ultimately Chief Executive and Chairman. John was non-executive Chairman of SPI prior to its demutualisation and acquisition by Abbey in 2001. He became a non-executive Director of SPL at the time of acquisition and a member of the Supervisory Committee in 2004.

### Derek Pike

The Demutualisation Scheme allows the Independent Member to nominate an Alternate Member and this role is fulfilled by Derek Pike, who qualified as a Fellow of the Faculty of Actuaries in 1982 and has many years' experience as a consultant.

## How can I find out more?

You can visit our website at:

[www.scotprov.co.uk/withprofitsupdate.html](http://www.scotprov.co.uk/withprofitsupdate.html)

You can write to us at:

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