A guide to how we manage units in our With-Profits Fund

You'll find important information about your policy and how it works in this guide. Please read this guide and then keep it safely with your other policy documents.

1. Who this guide is for and what you will find in it

This guide is for you and the other policyholders who are investing in the With-Profits fund of Scottish Provident Limited (Scottish Provident) and whose benefits are expressed as 'units'. A unit in a With-Profits fund represents a share in the assets of the fund. The guide explains:

- How the fund works
- What you should expect the fund to do for you
- What affects the value of your investment when the time comes to cash it in.

You can find full details of the fund and how it works in a document called the "Principles and Practices of Financial Management". This summary version tells you about the main points in the full Principles and Practices document dated January 2007. If we change the full document, we will tell you and if the change is an important one that affects your policy we will send you a revised guide like this one.

2. What you'll find in the following sections

Section 3. Your policy and our business

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3. Your policy and our business

Scottish Provident is a life insurance company that was set-up in 1837. From 2001 until 2006 the company was owned by Abbey National. In September 2006 the company was acquired from Abbey by Resolution plc. Resolution is a specialist in life assurance management and also owns a number of other life assurance funds.

Your policy may be an investment or you may be saving for a pension or to pay off a mortgage. Some of the money you pay to us may be used to cover running costs or for life assurance cover in case you die early. Most, however, will buy you units in one of our investment funds. In some of these funds the unit price goes up or down every day depending on how the investments are doing. You may, though, have opted to buy With-Profits units.

This guide is about the With-Profits units. These have some special features that we want to help you understand. We have several different series of With-Profits units. The series all operate on similar principles, but may have different charges or bonus rates.

Like all UK insurance companies, we are regulated by the Financial Services Authority and we always aim to operate within FSA requirements. We also follow rules that were approved by the court when Abbey took over Scottish Provident in 2001 and which continue to apply even though Abbey has sold Scottish Provident to Resolution. These rules include that:

- Scottish Provident must aim to set payments to policyholders so that there is no money in the fund when the last policy is paid off
- There are limits on the charges, fees or profits we can take out of the fund.

Over the years Scottish Provident has sold many different kinds of policy both in the UK and the Republic of Ireland. The unitised type of policy described in this guide was first offered in 1986. Although it was a new type of policy it was invested in a common fund alongside the older types of non-unitised policy many of which stayed on offer. We have other guides about the other types of policy.

4. How we work out what to pay you when your policy is cashed-in

When you invest in a policy, you buy units that you then sell back to us when your policy is cashed-in. We set the buying and selling prices. This section explains how we manage this so that policyholders are treated fairly.

We'd like to explain a few technical terms first:

- **Offer Price** – this is the price we use when you are buying units from us
- **Bid Price** – this is the price we start from if you are selling units back to us. There may be adjustments for **Market Value Reductions** or for **Final Bonus.**

For most series of units, the bid and offer prices differ by about 5%. For example, if the offer price was £1.00 the bid price might be 95p. This charge allows for the start-up expenses for a new policy and for some of our day-to-day costs. Some types of policy charge you for these costs in a different way and their units have the same bid and offer prices.

- **Annual bonus** – this tells you how fast the offer price and the bid price increase. If there is an annual bonus for your units then you should expect to see the bid and offer prices going up over a year by the amount of the bonus rate. Our newest series of units can have a zero annual bonus but our oldest series have a guarantee about annual bonus. The guarantee on these older units states that the bonus will not be less than 4% each year on pensions premiums paid in either the UK or the Republic of Ireland or less than 3% each year on life assurance premiums paid in the UK only. We stopped giving these guarantees when we started our new series of units in 1995 for life assurance premiums and in 1999 for pensions premiums.
- **Investment result** – this is the amount we credit to the value of your units. The fund owns a variety of investments. These produce interest and dividends. The fund also sees the benefit, or the cost, of capital gains and losses as, for example, shares go up and down in value on the stock market. In some years the capital losses could be larger than the income, leaving an overall loss. The fund has to pay tax and other charges. The tax is less on pensions policies than on life policies. Most series of units also have an annual charge. Sometimes there may be other gains or charges arising from our management of the costs of guarantees. There is more about charges and guarantee costs later. All of these factors make up the investment result that we work out each year.
- **Market Value Reduction**, or **MVR** – this is money we can take away from the bid price of your units if you cash-in your policy
- **Final bonus** – this is an increase to the bid price of your units that we may be able to give you when you cash in your policy.

There is more about how, why and when we use MVRs and final bonus later.

Smoothing

The investment result could be a gain or a loss. Smoothing can mean two things:

- Smoothing can mean not always allowing the value given for a policy to move up or down as quickly as changes in the investment result
- Smoothing can mean that if there are different investment results from one year to the next, we may use an average result.

In either case the full effect of the investment result is allowed for over time. We now have much less smoothing than we did a few years ago.

Market Value Reductions, or MVRs, and final bonuses

In most years, the investment result will be different from the annual bonus on your units. This could lead to unfairness with some policyholders getting too much and some not getting enough.
We can take two steps:

- If the annual bonuses have been too low we can add a final bonus when you cash-in your units
- If the annual bonuses have been too high we may be able to take off an MVR when you cash-in your units.

The aim of either type of change is to match up your cash-in value with the investment results. We expect to check the final bonuses and change them if necessary at least twice a year and to check and change the MVRs more often so that the value of your units follows the fortunes of the fund. If an MVR reduces the value of your units, the amount of the MVR stays in the fund and does not go to Scottish Provident or to Resolution. In the same way any final bonus is paid by the fund.

Many policies will have certain times or conditions when we have guaranteed that an MVR will not apply. These guarantees can be valuable and if you are considering cashing-in your policy at a time when an MVR is being charged it is always a good idea to check whether your policy has a guarantee date and how far away it is. You might want to take advice about whether it would be better for you to wait until you can claim the benefit from your guarantee.

A simple example of how annual bonus, MVRs and final bonus might work

Here is a very simple example of what can happen and what we might do. It uses some imaginary units whose history is:

	Annual bonus	Investment result for year	Difference for year
First year	2%	4% loss	–4 – 2 = –6%
Second year	0%	7% gain	+7 – 0 = +7%

Let's suppose that the unit price was £1 at the start of the first year. In the first year we had a bonus of 2%, so the unit price at the end of the first year is £1.02. But the fund lost money and the £1 worth of investments we bought is now worth only 96 pence. If you cashed in now we would be likely to charge you an MVR. This might be the full 6% difference or there might be some smoothing and the charge could be, for example, 5 pence.

At the start of the second year we have had a loss and are charging MVRs, so we decide to cut the bonus to zero to help get the unit price back in balance.

At the end of the second year the units have not had any more bonus and so the price is still £1.02. The investments, which were worth 96 pence at the start of the year, are now worth nearly £1.03, because the 96p has risen by 7%. We would no longer be charging any MVR, but would probably not yet be adding a final bonus.

Let's think now about a unit for a policy that began at the start of the second year. This would have quite a big difference between the bonus added (zero) and the investment result of 7%. We would be likely to have a final bonus for these newer units. This might be the full 7%, or there might be some smoothing and the final bonus might be, for example, 5%.

In this example we have used a policy paying only one premium and looking only at two years. In practice policies will often last for many years and things become more complicated, especially if the policyholder is paying premiums every year.

Special payout situations where MVRs may not apply
Endowment policies will usually have a guarantee that no MVR can apply on the normal maturity date and pensions policies will usually have a guarantee at the retirement date you chose when you took out the policy. Some With-Profits bonds have a guarantee on their tenth anniversary and on every fifth anniversary after the tenth. Bonds often also allow small withdrawals each year without us charging an MVR.

Most policies also guarantee that no MVR will apply to the amount paid out if the policy becomes payable on death and some have a guarantee after units have been invested for a set number of years.

All these guarantees can cost the fund money and there is more about how we manage this risk in section 6.

What happens if you cash-in, or "surrender" your life policy or "transfer" your pension policy early
If you cash-in your policy early, you will probably be doing so at a time when there is no guarantee. We will work out the value of the units that have already been bought for your policy. The normal bid price of your units may be changed because an MVR or a final bonus has been used.

There may also be an early surrender or transfer charge taken off the value of the units. This happens because we have quite heavy costs when your policy starts. If the policy runs for its full normal life then we recover these early costs from the annual management charges we mentioned earlier. If you cash-in your policy early we will not have had long enough to get our costs back and we have to take back the outstanding cost from the cash-in value. You were told about any early surrender or transfer charges on your policy in the papers you were given when you took out the policy.

Cashing-in early may mean you get back less than you have paid in.

What happens if you cash-in your policy on a guarantee date
If you are cashing-in your policy on a date when a guarantee applies, we will work out the value of your units using the normal bid price. We will not use any MVR. You will still be entitled to any final bonus. There will never be an early surrender or transfer charge on a guarantee date.

More about annual bonuses
An annual bonus increases your guaranteed benefit in situations where an MVR cannot apply, but there may be years when we do not have any annual bonus except for policies with a guaranteed annual bonus. Having no annual bonus does not mean that your units are not earning anything. The full amount of the investment result is still being used to help us decide the amount of any MVR or final bonus.

If there is an annual bonus then the guarantees get bigger and are more likely to cost the fund money. Different policies have different guarantees and some policyholders would benefit more than others. So sometimes it is fairer to have no annual bonus and use all the investment result to change MVRs and final bonus.

5. How the money in the fund is invested

The fund may use any of the usual types of investments. These include stocks and shares which are bought and sold on the stock-markets, unit trusts, fixed interest loans to local or national governments or to companies, and bank deposits. Some of the fund may be invested in land and property and in some less common investments.

History shows that company shares tend to do better than fixed interest loans in the long run, but the value of shares can go up and down quite a lot, with losses in some years. Because of the guarantees in the fund we are careful not to put too much into the type of stocks whose value might fall over short periods. We aim for a balance between choosing types of stocks that we think have a good chance of growing in value on one hand and not risking too great a loss on the other.

A typical mix of investments might be to have about half of the fund in fixed interest loans and about a third in shares on UK and overseas stock markets with the rest in a wider variety of investments. The actual mix at any time might be different. Our usual aim is to share in the overall movement of the market, rather than to try and choose individual stocks.

6. How we manage risk

This section tells you a little more about the main risks in the fund, how these might affect you and how we try to manage the risks.

Investment risk
The fund is not limited to investments guaranteed by big banks and governments. We aim to earn a higher return than deposits would earn, but you don't usually get offered a higher return unless there is also some risk of loss attached. We aim to limit the risk in two main ways:

- We put only part of the fund into shares on the stock-market and keep quite a large part in safer fixed interest loans
- We don't put too much money into any one stock or company. We spread the fund over a large number of separate investments.

Even so, the fund performance will be different from year to year and may be a profit or loss.

Guarantee risk
Each policy includes times when there is a guarantee about the amount to be paid. If these guarantees mean we are not charging an MVR when we normally would, then the guarantee is costing the fund money. This could mean there is less left in the fund for other policyholders.

Since the middle of 2004, we have been managing these guarantee costs through a complex set of 'fund protection assets'. These are special investments whose value changes with the overall level of the stock-market and as interest rates change. We invested about 6% of the fund to buy enough of these to match what we expected the current guarantees to cost. The value of these assets is designed to rise at times when other stocks are falling and the guarantees are more likely to cost more. The overall effect is that we have insured the fund against most of the guarantee costs, but the actual guarantee costs may turn out to be more or less than the fund protection assets. We will check and revise the position from time to time. Any changes may mean there is a cost or a gain to the fund and this will show up in the investment result.

Insurance risk
All policies include insurance benefits such as payments on death. It is possible that the actual cost of insurance might be different from what we expected. For our older types of non-unitised policy, these differences will contribute to the overall profits and losses in the fund. For example, the fund would make a profit if there are not as many early deaths among the endowment policyholders as we expected. The fund buys annuities for pensions policyholders on retirement. If pensioners are expected to live longer that will add to our costs. From time to time we will adjust the investment result for all policies to reflect these profits and losses.

7. Charges and expenses

Your policy has a set scale of charges. There are two main types of charge, charges based on the fund and the units and charges based on the policy.

The usual types of charge based on the fund and the units are:

- An annual management charge based on the value your units. After the purchase of Scottish Provident by Abbey, the level was agreed to be unchanged for 10 years. It is 1% for all units. Some pension units are charged an additional 3.25%. The rates charged to the investment result are lower. The difference between the rates may mean there is a cost to the fund, which would be spread across all policyholders.
- The difference between the offer price and the bid price.

The possible types of charge based on the policy are:

- A monthly policy fee, for example this might be £3 per month. This is usually charged by cancelling some of your units.
- The allocation rate – this means that we may not invest exactly what you pay us when we buy units. Some policies have a low allocation rate, for example 70%, in the first year or so. A 70% allocation would mean that out of every £1 you pay only 70p is used to buy units with the rest being used to pay some of our costs. Some may have an allocation rate over 100% that reduces the effect of the difference between the offer price and the bid price.

We explained about the charges on your policy in the papers you were given when you bought the policy. The charges were set when you bought the policy and we have only limited rights to change them.

Some policies include extra insurance benefits such as payments on death or certain serious illnesses. This extra insurance is normally charged for month-by-month by us cancelling some of the units you have already bought.

8. Our approach to new business

Our With-Profits fund is closed to new business and we have no current plan to re-open it.

Existing policies can continue to pay their normal regular premiums and these premiums continue to buy new units. Some existing policyholders also have rights to add to their existing investment in the fund. This is possible, but customers should always consider taking advice as to whether this is the best course of action for them.

9. What happens if the fund has too much, or too little, money

At the time of writing (December 2006) our best estimate was that the fund had slightly more than needed to settle all our policyholders' claims. We check the position at least twice a year. However, we can't be sure what will happen in the future and the balance could change.

For example:

- If the investments do much better than we expect, or if guarantees cost less than expected we might find the fund has extra money
- If the investments do less well than we expect or guarantees cost more than expected we might find the fund does not have enough money.

The key messages are that any extra money belongs to the policyholders. and if there is a shortage then at least part of this is likely to be charged to policyholders. However, if policyholders are likely to have their policy value reduced by more than 5% on account of such a shortage, then the company will share any excess over 5%. If there is extra, then one option would be to add this in when we work out the investment result that we use when deciding what we can afford to pay as final bonuses or whether we need to charge MVRs. In the same way if there is not enough then this could show up as a lower investment result, making final bonuses lower or MVRs higher. Guaranteed benefits cannot be reduced.

Scottish Provident and Resolution have other money earmarked outside the fund that is available if the 5% limit is reached or if there is a threat to guarantees. We would not normally expect to use money from outside the fund to support higher final bonuses or lower MVRs and we would be very unlikely to agree to use this money to help the fund support a new annual bonus as this would add to the guarantees. Adding to the guarantees can be very expensive and would be considered only if the fund, on its own, had a significant amount of extra money.

10. How to find out more

We hope this guide has been helpful, but remember you need to look at your other policy papers and your regular statements as well.

This is a summary version of our full Principles and Practices document. Some of the more technical details have been left out. We have tried to select the main points that affect most policyholders. If you want more details about the fund you can ask for a copy of the full Principles and Practices document or you can download it from our website. If you need more information about your own policy then you can phone or write to us.

This guide aims only to help you understand your contract. It does not aim to change the contract between us or to give you advice. We suggest you should always speak to a financial adviser before taking any decisions about your investment.

Our contact details are:

If you want to ask about your own policy you can phone us:

- Customers with endowments, flexible lifetime plans, regular savings plans and critical illness cover phone **0845 741 3002**
- Customers with With-Profit Bonds phone **0845 6000 403**
- Customers with pensions plans phone **0845 270 1075**

Or you can write to us at Scottish Provident Limited plc, 301 St Vincent Street, Glasgow G2 5NB.

If you want a copy of our full Principles and Practices document then either:

- Phone **0845 741 3002**; or
- Try our website **www.scotprov.co.uk/withprofitsupdate**

Technical questions about the content of this document or about the full Principles and Practices document are best put in writing to the With-Profits Actuary's Department at the postal address above.

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