PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT

THE SCOTTISH LIFE CLOSED FUND

REPORT TO WITH PROFITS POLICYHOLDERS ON COMPLIANCE FOR 2016

JUNE 2017

CONTENTS

1. INTRODUCTION

On 30 April 2004 The Royal London Mutual Insurance Society Limited ('Royal London') first published its Principles and Practices of Financial Management ('PPFM') for the Scottish Life Closed Fund ('the fund'). The most recent version was published in December 2016 to reflecting the changes that permit more freedom to invest in new asset types.

The Directors must provide a report each year to with profits policyholders giving information on compliance with the PPFM. The Directors have reviewed the operation of the fund for 2016 and in their opinion the PPFM has been complied with in full. It is also their opinion that the exercise of discretion over the period was appropriate and that any issues involving competing or conflicting rights, interests and expectations of policyholders were resolved fairly.

In coming to this view the Directors have taken account of internal and external professional advice provided during the year, including advice from the With Profits Actuary, the With Profits Committee and the Chief Actuary. This report sets out the main reasons for the Directors' opinion and the following sections consider, in turn, governance, the exercise of discretion, competing and conflicting interests, and compliance with the PPFM.

2. GOVERNANCE

Appropriate governance arrangements to monitor compliance with the PPFM have operated throughout the period in question.

The Directors seek opinions as appropriate from the With Profits Actuary, from the Chief Actuary and from the With Profits Committee which was established by the Directors to provide independent advice on the way the fund is managed, to provide an independent view when the Directors are considering the interests of with profits policyholders and to monitor compliance with the PPFM.

The Supervisory Committee which monitors that the fund is managed in accordance with the terms of the Scheme of Transfer was in operation during the period. The Committee has sought additional information from management during the course of the year in order to be satisfied that the terms of the scheme have been adhered to. The Committee has been content with the information provided and has confirmed that the fund has been managed appropriately.

A short report to policyholders from the With Profits Actuary confirming his view is attached.

3. EXERCISE OF DISCRETION

The main areas in which discretion is exercised in the operation of with profits business are setting bonus rates, investment strategy, setting surrender values, allocation of expenses and the management of the estate.

SETTING BONUS RATES

For all contracts we carried out a process, in line with the PPFM, to set annual and final bonus rates for 2016. The annual bonus rates were implemented on 1 January 2016 and were not changed during the year. They were first approved on an interim basis and declared formally at the end of March 2016. Final bonus rates were declared twice during 2016, in January 2016 and July 2016 respectively.

In making these declarations the Directors took account of advice from the With Profits Actuary, the Chief Actuary and followed the requirements of the PPFM. The Directors also took account of advice from the With Profits Committee.

INVESTMENT STRATEGY

Prior to 2016 the asset mix for an individual plan varied according to its outstanding term and the level of guarantees. This approach was simplified at the start of 2016. With interest rates at or close to historic lows, we have moved away from varying the asset mix by outstanding term. Different asset mixes continue to be attributed to different plan types. Those plans with higher levels of guarantees are invested more conservatively.

The aim of the investment strategy remains to maximise the long term return on investments for with profits policyholders whilst recognising the need for the fund to meet its guaranteed liabilities and commitments to policyholders and maintaining the estate at or close to the target size.

A common statistic used to categorise the level of investment risk within a fund is the proportion of the fund's assets that are invested in equity and property. At the end of 2016, the overall proportion backing conventional with profits business was 15% and 25% for unitised with profits business.

SETTING OF SURRENDER VALUES

The normal regular reviews of market value reduction (MVR) factors and surrender bases for conventional with profits contracts were carried out. Changes to these factors and bases took place following the bonus declaration as at end of 2015 and as at end-June 2016. No further changes were made for during 2016.

ALLOCATION OF EXPENSES

Since 1 July 2011, following the expiry of the 10 year expense agreement specified in the original transfer agreement between Royal London and Scottish Life, our aim is to allocate expenses to policies that correspond to the actual expenses incurred. Over the course of 2016 the expenses allocated to with profits policies were compared to the actual costs of administering those policies. The expenses allocated to with profits policies were confirmed as being appropriate and in line with the PPFM.

MANAGEMENT OF THE ESTATE

There were no material changes to the methods of monitoring and managing the estate during 2016 as they continue to operate effectively.

MANAGEMENT OF RISK

Royal London continuously seeks to obtain independent assurance that its systems of risk management and internal control are operating effectively. In addition we obtain independent opinions on the effectiveness of the key systems and controls throughout the organisation. This includes evaluating the effectiveness of, and the adequacy of, the risk management processes and ensuring compliance with policies and procedure. The effectiveness of internal control and the risk management infrastructure is also specifically considered by our external auditors in the context of their review of our financial statements.

We have previously developed a number of actions to mitigate the business risks that are run within the fund including exposures to investment, expense, mortality, morbidity and lapse risks.

CHANGES TO PPFM

An updated version of the PPFM was published on 31 December 2016 reflecting the changes that permit more freedom to invest in new asset types. All changes to the PPFM are approved by the Directors.

4. COMPETING OR CONFLICTING RIGHTS, INTERESTS AND EXPECTATIONS

In any with profits fund, different groups of policyholders could have competing or conflicting interests. For example, holders of

- policies of different types (such as life or pension policies or regular or single premium)
- policies of different sizes or different policy terms
- policies which started in different years or mature in different years

or policyholders

- of different ages
- claiming for different reasons (for example maturity, death, surrender)
- exercising different policy options

could receive different benefits relative to each other depending on how discretion is exercised.

Any conflicts which have arisen have been appropriately and fairly resolved, in the Directors' opinion, after taking expert advice, where necessary. This expert advice has been provided by the With Profits Actuary, the Chief Actuary and the With Profits Committee as appropriate.

5. COMPLIANCE WITH PPFM

MANAGEMENT OF THE ESTATE

During 2016, the Directors were provided with information and actuarial reports on a regular basis regarding the current and projected financial position of the fund.

Changes to insurance regulation known as 'Solvency II' were introduced on 1 January 2016. Solvency II increased the amount of capital we have to hold for the risks in the fund. As a result, we have maintained the demutualisation enhancement approach that we have used in recent years. This approach involves increasing target payout ratios rather than enhancing asset shares as this is more capital efficient. The target payout ratio was 118% of asset share for policies claiming in the first half of 2016. As a result of the falls in interest rates associated with the EU Referendum, the financial position of the fund deteriorated and target payout ratios were reduced to 112% of asset share for policies exiting the second half of 2016.

INVESTMENT STRATEGY

During 2016 the Capital Management Committee met 20 times. Technical papers on investment strategy were presented during the year and advice from the With Profits Actuary and the Chief Actuary was obtained where appropriate.

The performance of the investment manager was monitored by the Capital Management Committee, the Investment Committee and the Directors. Changes to benchmarks were approved by the Directors.

POLICY BENEFITS PAYABLE

The methodology used to set bonuses and policy benefits followed the approach set out in the PPFM and complied with the terms of the Scheme of Transfer. The bonus rates declared differed between product types and classes.

An exercise to review compliance with the target ranges for maturity and surrender payouts published in the PPFM was carried out. This demonstrated that 98% of policies were within target range during 2016 as detailed below, satisfying requirements for compliance.

	Total asset share included in investigation	Proportion of claims		
		Below Target Range	Within Target Range	Above Target Range
All Claims	£88.3m	0%	98%	2%

6. CONCLUSION

In the opinion of the Directors the management of the with profits business in the fund over this period has complied with the PPFM in full. It is also their opinion that the exercise of discretion over the period was appropriate and that any issues involving competing or conflicting rights, interests and expectations of policyholders were resolved fairly.

P LONEY

GROUP CHIEF EXECUTIVE

28 June 2017

REPORT FROM THE WITH PROFITS ACTUARY

To with profits policyholders in the Scottish Life Closed Fund

In my opinion the discretion exercised by the Directors in respect of the period covered by their report has taken policyholders' interests into account in a reasonable and proportionate manner. It is also my opinion that the Directors have complied with the requirements of the Principles and Practices of Financial Management (PPFM) of the Scottish Life Closed Fund in full.

I have based these opinions on the information and explanations provided to me by the Directors and management of Royal London and on my own knowledge and investigations. In doing so I have taken into account the relevant rules and guidance of the Financial Conduct Authority, of the Prudential Regulation Authority, of the Financial Reporting Council and of the Actuarial Profession regarding the management of with profits business. In particular I can confirm that my report is compliant with the Technical Actuarial Standards (TAS R and TAS I) issued by the Financial Reporting Council.

Separate reports confirm compliance in respect of the Royal London Long Term Fund (excluding the Closed Funds), in respect of the PLAL With-Profits Sub-fund, in respect of the Royal Liver Sub-fund and in respect of the Royal London (CIS) Sub-Fund.

Brian Murray FFA

With Profits Actuary

5 June 2017