

# Report to Clerical Medical UK With-Profits Policyholders

Report on Principles and Practices of Financial Management (PPFM) for 2014

Clerical Medical closed to new business in Hong Kong on 1 January 2005.

This document has been produced in accordance with UK regulatory requirements.  
It has not been produced to promote or encourage further investment.



## Report on Principles and Practices of Financial Management (PPFM) for 2014

This annual report tells you how we have managed our With-Profits Fund in line with our published principles and practices – our PPFM. The PPFM goes into great detail, focusing 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.

Clerical Medical Investment Group Limited (we use 'Clerical Medical' or 'we' in the rest of this document) runs one With-Profits Fund. All the different types of with-profits policies sold in the UK, Europe and other overseas markets are supported by the same Fund.

This annual report:

- describes how we have exercised our discretion and
- responds to frequently asked questions.

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', a customer friendly PPFM. The current version is also available on our website: [www.hke.clerical-medical.com](http://www.hke.clerical-medical.com)

If you have any further questions please contact us on:

Hong Kong – **+852 2956 1288**

The Board of Clerical Medical met on 26 March 2015 to consider the matters covered in this report and the evidence presented to them by the With-Profits Actuary, together with advice from the independent With-Profits Committee. The Directors are satisfied that the With-Profits Fund has been managed in accordance with the Principles and Practices of Financial Management in all material respects.

The Directors of Clerical Medical  
26 March 2015

### 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 aiming to pay out a fair share of investment performance to with-profits policyholders;
- By aiming to achieve growth over the long term by having a significant proportion of the assets in higher-risk assets such as company shares and property, whilst ensuring that we can meet the Fund's guarantees;
- By aiming to smooth through some of the peaks and troughs of stock market values; and
- 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.

### 2. Frequently asked questions

#### Q1 What were investment returns like in 2014?

Share markets provided only modest returns in 2014, with the FTSE-100 index of leading UK shares rising by just 1% (including reinvestment income). Positive views by investors of economic progress in the UK have been offset by uncertainty driven by geo-political events such as the ongoing tensions between Russia and the rest of the world, the emergence of Islamic State in the Middle East and the Ebola crisis in West Africa. Falling commodity prices have also held back equity market returns with the oil and gas sector suffering particularly heavy losses as the price of crude oil dropped towards a five-year low at the end of the year.

Further reductions in investors' expectations of future interest rates and inflation contributed to a good performance from fixed interest bonds issued by the UK government, with the FTSE index of 5-15 year UK bonds rising 12% (including reinvestment income). Fixed interest bonds issued by companies also rose in value, as did the commercial property market.

Against this background our With-Profits Fund produced an investment return on assets backing policies of 7.1% in 2014, largely reflecting the strong performance from the Fund's fixed interest and property investments. (These assets backing policies, called asset shares, are described below).

## Q2 What is your investment policy?

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

- Asset shares are the amount resulting from investing premiums less deductions on typical policies, and they represent a fair share of the Fund for those policies. A significant proportion of the assets which support the asset shares is usually 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 offshore 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 UK 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 possible long-term performance; and
- making sure that the with-profits fund can always meet its guarantees (also taking account of the assets in the estate).

For UK asset shares in 2014 we:

- Carried out a small reallocation of company shares, from developed economies to emerging markets, to improve further the diversification of the fund's investments between different economies and industries. We hedge out the fund's exposure to major overseas currencies.
- Made a further reduction in the Fund's exposure to fixed interest UK government bonds, which we started to reduce in 2011. Though these bonds have performed well in the recent past we do not expect this to be maintained.
- We also reduced exposure to fixed interest bonds issued by companies in 2014, for similar reasons. These are shown as 'Corporate bonds' in the table below.
- At the end of the year the sale proceeds from these corporate bonds were temporarily invested in cash deposits, awaiting investment into short to medium term loans secured against commercial property. The returns on these loans are attractive relative to the risk of default by the borrowers, and the security of the underlying properties helps to manage this risk.

Our investment managers are given scope to vary from the strategic mix selected by the Board, based on a shorter-term view of how different types of asset and regions will perform.

The mix of investments backing UK asset shares has been as follows. The changes over the year reflect the combined effect of:

- The strategy changes described above.
- Changes in the shorter-term positioning taken by the investment managers.
- The relative movement in different markets (a strongly performing type of asset will tend to increase as a proportion of the fund naturally).

	31-Dec-12	31-Dec-13	31-Dec-14
<b>Fixed interest</b>			
• UK government bonds	11%	10%	6%
• Corporate bonds	17%	16%	13%
• Overseas bonds	1%	0%	0%
<b>Property</b>	14%	14%	13%
<b>Equity shares</b>			
• UK shares	28%	20%	18%
• Non-UK shares	15%	25%	24%
<b>Absolute Return</b>	6%	8%	9%
<b>Other investments (including cash deposits)</b>	8%	7%	17%

Note: An Absolute Return asset is one which aims to generate investment performance from relative stock movements rather than from the general performance of an asset class.

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 websites [www.clericalmedical.co.uk](http://www.clericalmedical.co.uk) or [www.offshore.clericalmedical.com](http://www.offshore.clericalmedical.com)

### **Q3 How did you set regular bonuses in 2014?**

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 didn't set rates this way the guarantees in the Fund could become big enough to force us to increase the percentage of the Fund's assets invested in fixed interest assets. 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.

We maintained, and in some cases increased, regular bonus rates from February 2014, reflecting the continuing financial strength of the Fund. Only small changes were made to some rates in February 2015, though they 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 Q4).

### **Q4 How did you set final bonuses and market value reductions that applied to payouts in 2014?**

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 so policyholders will also benefit from the rest of those investment returns.

For unitised policies, if you come to take money out of the 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 meant your investment would be worth more than your fair share (the asset share as explained in Q2). In this event, the MVR would have the effect of reducing the amount paid out, so that it 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 these policies will have experienced different investment returns over their 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 2014 and 1 August 2014. As a result of these reviews the level of payouts increased for the majority of policyholders over 2014. This reflected the combination of market movements and a small reduction in the level of distribution of excess estate (please see below).

#### **Distribution of excess estate**

At least once a year, we determine whether the estate is more than is needed to meet the aims of the prudent management of the Fund. A distribution of excess estate was started from 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 2014 a small decrease was made in both February and August 2014, but the remaining distribution is still adding around 11% 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% 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.

To support our aim that the Fund continues to be well equipped to react to a range of investment conditions, we 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 2014 had the result that asset shares were increased by 0.1% from 1 April and by a further 0.1% from 1 October.

We aim to pay amounts that are within 20% of the asset share. We achieved this for the vast majority of policies in 2014 (other than any policies where payouts were higher due to guarantees).

## Guarantee Costs

We guarantee a minimum payment from your policy on 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 Fund. The deduction applied in 2014 was 0.5% for premiums paid before 1 January 2008, and 0.1% 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 cost. This is in line with our published policy.

### **Q5 How do you determine the administration costs to be charged to the With-Profits Policyholders?**

For all unitised business sold since 1996, there are no deductions for administration expenses 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 traditional business there are no stated deductions for charges. Instead we deduct an amount to cover the expenses of running the traditional policies including administration expenses, 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 rates charged by other companies. One of these periodic checks was carried out in 2014 and confirmed that our charges are in line with other companies. 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.

### **Q6 What is your position with regard to accepting new with-profits business?**

Over the last few years, the number of new customers investing in the Fund has reduced. This reflects a general 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 is therefore reducing as they 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 also expect to continue to benefit from a diversified investment policy and from the smoothing of returns (Q4 explains smoothing).

### **Q7 What role does the With-Profits Committee play?**

Clerical Medical has an independent With-Profits Committee. It reviews how the 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.

The Committee has four members, none of whom have any management or executive role with Clerical Medical (or our parent company, Lloyds Banking Group). One member is a non-executive director of Clerical Medical and another recently held that position. The terms of reference set out the responsibilities of the Committee, and can be found at: <http://reference.clericalmedical.co.uk/docs/E2088.pdf>

### **Q8 What other reassurance do I have that you have treated customers fairly and in line with your 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 Q7.
- Whenever we make important choices that affect the way we manage our with-profits policies, our With-Profits Actuary, who advises the Board of Clerical Medical presents a report for the directors giving the reasons behind the proposals and how these comply with the Principles and Practices of Financial Management.
- Throughout the year, all the data, work and actions that supported our decisions have been recorded. The With-Profits Actuary has reviewed this evidence and is satisfied that the decisions were consistent with the Principles and Practices of Financial Management, the Financial Conduct Authority (FCA) rules on Treating With-Profits Customers Fairly and the Clerical Medical Scheme of Transfer. 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 Principles and Practices of Financial Management 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, who review various aspects of our business and controls. Input from an independent actuary is also sought when appropriate, though there has been only a limited need for this in 2014.

## 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' customer-friendly PPFM).
- With-profits investment factsheet.

You'll find copies of these documents and the latest information on bonus rates and market value reductions (MVR) on our website: [www.hke.clerical-medical.com](http://www.hke.clerical-medical.com)

### Statement from the With-Profits Actuary

In my opinion the discretion exercised by Clerical Medical during 2014, 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 Clerical Medical, including information requested by me, and the relevant rules and guidance issued by the Financial Conduct Authority.

Taking account of the information being provided in the report from the directors, this statement complies with the technical standards on data, insurance, modelling and reporting issued by the Financial Reporting Council.

Kevin Doerr  
Fellow of the Institute and Faculty of Actuaries  
With-Profits Actuary  
26 March 2015

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CMI Insurance Company Limited, Clerical Medical House, Victoria Road, Douglas, Isle of Man IM99 1LT, British Isles. Registered no. 33520 Isle of Man. Telephone +44 (0)1624 638888. Authorised by the Isle of Man Insurance and Pensions Authority.

Hong Kong Representative: CMI Financial Management Services Limited, 26/F, Oxford House, Quarry Bay, Hong Kong. Telephone: +852 2956 1288. Fax: +852 2956 2302.