

# Demutualisation Scheme Proposal – Mortgage Endowment Promise

ADVISER BRIEFING

This briefing is intended for qualified financial advisers only and must not be relied on by anyone else.

This Adviser Briefing is a summary and therefore does not set out all of the detailed aspects of the proposals regarding the Mortgage Endowment Promise. If there is any inconsistency between this Adviser Briefing and the Main Scheme (as defined in the *Proposal for members and policyholders*, being an insurance business transfer scheme under Part VII of the Financial Services and Markets Act 2000), the Main Scheme prevails.

## Introduction

Towards the end of 2000, Standard Life issued the Mortgage Endowment Promise (“the Promise”) to certain of its UK and Irish mortgage endowment policyholders in an attempt to allay the concerns of these policyholders about the extent to which maturity payments under their policies might fall short of the target amount. The Promise is dependent on the growth in the Company’s capital being enough to allow us to set aside regular provisions to provide this financial support in the future.

In October 2004, the Company announced that the capital growth condition had not been met, that it was unlikely to be met in the foreseeable future, and that it would be inappropriate to make further provisions in respect of the Promise while this was the case. We also announced that, as long as it was fair and prudent to do so, the provisions already set aside for the Promise would be used to pay amounts to certain policyholders according to the terms of that announcement.

Now, as part of the demutualisation scheme, it is necessary to define more precisely how the Promise should operate in practice within the changed corporate structure of the Standard Life group. This is necessary because the capital growth condition is currently open to a number of different interpretations. These changes are intended to ensure that the obligations in respect of the Promise can operate with certainty after demutualisation and in a manner that is fair to all policyholders.

## Key Points

- This briefing provides a summary of the proposed changes. Full details are contained in the *Proposal for members and policyholders*, which can be found at [www.standardlife.com](http://www.standardlife.com).
- The demutualisation scheme will replace the capital growth condition with an alternative measure. This alternative measure will be based on a primary component of capital growth, namely investment return, on a pool of with profits assets.
- To provide clear guidance on what levels of payments may be made, we will compare the actual investment return on these assets with a published table of pre-determined investment thresholds (as shown in Table 1 overleaf).
- There will be clear steps for determining whether a payment is payable under the Promise and, if so, how much. This note explains these steps in more detail. Generally speaking, we expect the amounts payable to be broadly equivalent to those that would have been paid by Standard Life in accordance with the letter sent to policyholders after the announcement was made in October 2004 (referred to in this note as the “Basic Amount”). However, if actual investment returns on the pool of with profits assets are sufficiently high, this Basic Amount may be increased. Conversely, the Basic Amount may be reduced if investment returns on these assets are very low.



## Glossary of Key Terms

<i>Shortfall Amount</i>	The amount by which the actual proceeds paid on maturity fall short of the original target amount.
<i>Maximum Top-Up</i>	This is a fixed amount that was calculated shortly after the Promise was first introduced. It is the excess of the original target amount over the projected maturity value calculated at that time assuming a 6% p.a. future investment return (after tax) on the assets in which the Promise policy was invested. If the projected maturity value was greater than the original target amount, the maximum top-up equals zero (although a top-up payment may still be made if the 6% p.a. Test is satisfied – see Step 2 overleaf).
<i>Basic Amount</i>	<p>The basic amount of top-up which is calculated as a proportion of the Maximum Top-Up (or a proportion of the Shortfall Amount if the 6% p.a. Test is satisfied – see Step 2 overleaf) The proportions vary according to the year in which the policy matures:</p> <ul style="list-style-type: none"> <li>● 2005 100%</li> <li>● 2006 80%</li> <li>● 2007 60%</li> <li>● 2008 and after* Estimated as between 40% and 60%</li> </ul> <p>*The proportion from 2008 onwards will be influenced by a number of factors and could be outside the range shown.</p>

## How top-ups will be calculated after demutualisation

### Step 1 - The Investment Return Test

The Investment Return Test has been introduced to replace the capital growth condition of the original Promise as explained above.

The actual annualised investment return (the 'Actual Rate') on the **pool of assets backing UK with profits asset shares** for the period 1 October 2005 to the most recent 30 September prior to maturity (the relevant 'calculation period') is compared against a range of pre-determined investment thresholds as shown in Table 1. The demutualisation scheme allows for this calculation to be made at the end of March, June or December, as well as September, if the Board considers this appropriate to maintain fairness. An example where such action might be taken is where there are large movements in investment markets.

The investment thresholds cover four bands and are referred to as the Cessation Rate, the Reduction Rate, the Accelerated Rate and the Target Rate. Table 2 (overleaf) describes how the actual return relative to these threshold rates is used in the calculation of top-up amounts.

**Table 1**

Annual rate of return applicable to calculation periods ending on 30 September															
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Target Rate	20.4%	12.7%	10.1%	8.8%	7.9%	7.4%	7.1%	6.8%	6.5%	6.3%	6.1%	5.9%	5.8%	5.7%	5.6%
Accelerated Rate	8.8%	7.9%	7.4%	7.1%	6.8%	6.5%	6.3%	6.1%	5.9%	5.8%	5.7%	5.6%	5.6%	5.6%	5.5%
Reduction Rate	-12.6%	-4.5%	-1.9%	-0.6%	-0.1%	0.3%	0.6%	0.8%	1.0%	1.2%	1.4%	1.6%	1.7%	1.8%	1.9%
Cessation Rate	-13.7%	-5.1%	-2.3%	-1.0%	-0.3%	0.1%	0.4%	0.7%	0.8%	1.1%	1.3%	1.4%	1.6%	1.7%	1.8%

Note: These rates will be modified slightly if the calculation period ends on any date other than 30 September.  
Full details are contained in the *Proposal for members and policyholders*.

## Step 2 - The 6% p.a. Test

The next step is to carry out the “6% p.a. Test”. This is in accordance with how the Promise was originally defined in 2000.

Is the return on the **assets in which the Promise policy is invested** greater than or equal to 6% p.a., after tax, over the period from the introduction of the Promise to the maturity date?

**If No** The Promise amount cannot exceed the *Maximum Top-Up*.

**If Yes** The Promise amount could be **up to** the full *Shortfall Amount*, even if this is higher than the *Maximum Top-Up*. This means that policyholders who have a maximum top-up of zero may still receive a payment if the 6% p.a. Test is satisfied.

This calculation will be made at maturity for each policy.

The result of the 6% p.a. Test in combination with the relevant rate of return taken from Table 1 is used to determine the payment as shown in Step 3.

## Step 3 – Determine payment

Table 2

Actual Rate	Promise amount	
	6% p.a. test satisfied	6% p.a. test not satisfied
Equals or exceeds the Target Rate	<i>Shortfall Amount</i>	<i>Maximum Top-Up or Shortfall Amount, if less</i>
Is greater than the Accelerated Rate but less than or equal to the Target Rate	An amount more than the <i>Basic Amount</i> (see Note 1)	An amount more than the <i>Basic Amount</i> (see Note 1)
Is greater than or equal to the Reduction Rate but less than or equal to the Accelerated Rate	<i>Basic Amount</i> (see Note 1)	<i>Basic Amount</i> (see Note 1)
Is greater than the Cessation Rate but less than the Reduction Rate	An amount more than nil but less than the <i>Basic Amount</i> (see Note 1)	An amount more than nil but less than the <i>Basic Amount</i> (see Note 1)
Is less than or equal to the Cessation Rate	Nil	Nil

### Notes

1. The *Basic Amount* in Table 2 is based on the percentages shown in the Glossary of Key Terms. If the 6% p.a. Test is satisfied, the appropriate percentage is applied to the *Shortfall Amount* to determine the *Basic Amount*. If the 6% p.a. Test is not satisfied, the appropriate percentage is applied to the *Maximum Top-Up* to determine the *Basic Amount*. The example overleaf illustrates how this will work in practice.
2. Where the Promise amount payable is higher or lower than the *Basic Amount*, it will be calculated on a pro-rata basis according to how the Actual Rate for the relevant calculation period compares to the investment returns set out in Table 1. This process is also described in the worked example.
3. The Promise amount payable will never be more than the actual shortfall on the policy.
4. This approach will apply to maturing policies up to 2020. For the relatively small number of policies that mature after 2020 (less than 10% of policies currently eligible for a payment under the Promise), Promise amounts will be broadly similar to those amounts being paid in the period just before 2020. Full details are included in the *Proposal for members and policyholders*.
5. Table 2 has been colour-coded to correspond with the threshold rates in Table 1 and the worked example overleaf.

## Example - Actual Rate between the Accelerated Rate and the Target Rate

**IMPORTANT NOTE:** This example is purely for illustrative purposes. Accordingly, no comparisons should be drawn with this example to predict what, if any, actual payments will be made under the Promise

Consider a Mortgage Endowment Promise policy maturing in June 2013

The applicable Calculation Period is the period ending 30 September 2012 (*assuming this to be the most recent Calculation Period prior to the maturity date*)

Therefore the **Target Rate = 7.1%** and the **Accelerated Rate = 6.3%** (from Table 1)

At the first review after the introduction of the Promise, let us assume that:

- Target amount = £50,000
- Projected maturity value = £46,000
- Therefore the **Maximum Top-Up = £4,000** (i.e. £50,000 - £46,000)

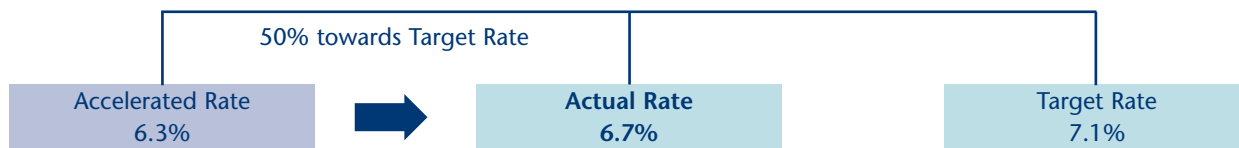
Let us assume further that as at the maturity date:

- Actual maturity proceeds = £42,000
- Therefore the **Shortfall Amount = £8,000** (i.e. £50,000 - £42,000)
- The relevant proportion being used to determine the Basic Amount = **50%** (i.e. the mid-point of the estimated range 40% to 60%)

The amount payable under the Mortgage Endowment Promise will depend on the Actual Rate

This is the rate of investment return earned on UK With Profits Asset Shares from 30 September 2005 to the end of the applicable Calculation Period (30 September 2012). Let us suppose the **Actual Rate = 6.7%**.

The Actual Rate can be compared to the Target Rate and the Accelerated Rate, as follows:



The amount payable will also depend on whether or not the 6% p.a. Test is satisfied

For the 6% p.a. Test to be satisfied the assets in which the policy is invested must have earned, on average, a return of 6% p.a. from the date the Promise was introduced to the maturity date.

- If the 6% p.a. Test is not satisfied, the Basic Amount is £2,000 (i.e. 50% of £4,000, the Maximum Top-Up)
- If the 6% p.a. Test is satisfied, the Basic Amount is £4,000 (i.e. 50% of £8,000, the Shortfall Amount)

If the 6% p.a. Test is not satisfied, the amount payable will lie between the Basic Amount (£2,000) and the Maximum Top-Up (£4,000), depending on where the Actual Rate lies between the Accelerated Rate and the Target Rate. In this example, **the Promise amount payable would be £3,000**



If the 6% p.a. Test is satisfied, the amount payable will lie between the Basic Amount (£4,000) and the Shortfall Amount (£8,000), depending on where the Actual Rate lies between the Accelerated Rate and the Target Rate. In this example, **the Promise amount payable would be £6,000**



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