October 2007

Understanding with profits

STANDARD LIFE

Summary: how your with profits investment works

We aim to treat all planholders fairly. Changes in your annuity income take account of the returns on the assets we invest in, our deductions, and any discretionary adjustments (up or down) that we make and the guarantee we provide.

We invest in a wide range of assets, including equities (company shares), property and bonds (loans to governments or companies). These types of assets can rise or fall in value. When we change your annuity income we may smooth out some of the effects of short-term changes in asset values. We may hold different mixes of assets to back different classes of with profits plan. This mix of assets may change over time.

The remainder of this booklet provides further information on how your with profits investment works.

How your Standard Life with profits investment works

Contents

1. Introduction

This booklet tells you how we manage our With Profits Pension Annuity business only. Other types of with profits plans that Standard Life operates in the UK are covered in separate Understanding With Profits booklets.

This Understanding With Profits booklet is intended only to give a simplified description of how we manage this with profits business. It does not in any way:

Your plan documents define the terms and conditions that apply to your plan.

- vary the existing terms and conditions of your plan;
- create any new or additional obligations; or
- restrict the way we manage our with profits business.

We set out a fuller, more technical description of how we manage our With Profits Pension Annuity business in a separate document called Principles and Practices of Financial Management for the Heritage With Profits Fund (the Heritage PPFM). Please see the Heritage PPFM if you want more information on the topics covered in this booklet.

Our website www.standardlife.co.uk/withprofits will always have the most up-to-date version of all Understanding With Profits booklets and of the Heritage PPFM. You can also get copies by contacting us on 0845 60 60 007. (Call charges may vary.)

If we make any changes to the Heritage PPFM that materially change this booklet, we will send you a new booklet at or before the time we send you your next yearly statement. We will also send you a booklet if we propose to change any of the principles we apply in managing this with profits business.

2. What is a with profits investment?

Your with profits investment provides a share in the performance of a relevant with profits fund. The relevant with profits fund (the fund) is the mix of assets that we hold to back our With Profits Pension Annuity business. In addition your annuity has certain guarantees, and we may apply smoothing to investment returns. We give more details about guarantees, smoothing, and which assets we invest in, later in this booklet.

See section 3 "How do we set payouts?"

Once in payment the level of your annuity income will vary from year to year depending on various factors.

At least once a year we declare a rate of return, the 'Declared Rate of Return', which we use to calculate the changes in your annuity income.

See "How we decide the Declared Rate of Return" in section 3.

When you took out your plan you chose a rate of return called the 'anticipated bonus rate'. We change your annuity income on every anniversary of your first annuity income payment if the Declared Rate of Return differs from your anticipated bonus rate. To maintain fairness to all with profits planholders we may also change your annuity income at other times by declaring a new rate of return.

The way we would change your annuity income means that:

- if the Declared Rate of Return is higher than the anticipated bonus rate, your annuity income would go up; and
- if the Declared Rate of Return is lower than the anticipated bonus rate, your annuity income would go down.

You can alter your anticipated bonus rate at any time after the first anniversary of your annuity start date.

3. What affects how much you may get?

The starting level of your annuity income depends on several factors including the payment you make to us and the anticipated bonus rate you choose. After that, the level of your income depends on the anticipated bonus rate and the Declared Rates of Return. We aim to treat you fairly.

How we decide the Declared Rate of Return

When we decide the Declared Rate of Return we start with the investment returns on the assets we hold to back our With Profits Pension Annuity business. We then make adjustments for such things as our expenses, a contribution to the capital of the Heritage With Profits Fund, smoothing, costs of guarantees, and any distribution of inherited estate. The result, subject to the guarantee, is the Declared Rate of Return.

The Declared Rate of Return can vary substantially from one declaration to the next, despite any smoothing of investment returns.

We give more detail about expenses, smoothing, and the inherited estate later in this booklet.

We publish information on the asset mix for different classes of with profits plans on our website at www.standardlife.co.uk/withprofits. You can also get a copy of this information by contacting us on 0845 60 60 100. (Call charges may vary.)

See section 4 “What is smoothing?”

What are the guarantees?
Your annuity income can go down as well as up, even after adjustment for smoothing. However, we guarantee that the lowest rate of return we will declare in any one year is minus 10%. Your annuity income could go down by more than 10% if you have chosen an anticipated bonus rate more than 0%.

What happens if you decide to move out of with profits?
You can move out of with profits at any time after the first anniversary of your annuity start date by converting your annuity to a conventional annuity. A conventional annuity provides an income that either remains level or increases at a fixed rate or tracks the Retail Prices Index. We would use your fair share of the fund to calculate the level of your annuity income under the conventional annuity. We would not smooth investment returns when calculating your fair share of the fund. This is to maintain fairness between those who remain in with profits and those who choose to move out.

We recommend that you seek advice from your financial adviser if you are thinking about ending your with profits investment.

4. What is smoothing?

We hold a wide range of assets to back with profits plans. The return on these assets will vary over time. One year the assets could go up in value, but the next they could go down. We aim to even out some of the fluctuations in investment returns to reduce the immediate impact of short-term changes in asset values on annuity incomes.

Smoothing is the name we give this process.

Smoothing evens out some of the effects of short-term changes in asset values. In the longer term:

- smoothing will not protect planholders from long-term falls in the value of the backing assets;
- smoothing will not stop planholders benefiting from the effects of long-term improvements in the value of the backing assets.

Smoothing may result in the annuity income payments for any individual being higher or lower than they would have been without smoothing.

We may sometimes reduce the amount of smoothing or apply no smoothing of investment returns at all. We may do this, for example, if there has been a rapid fall in the value of assets.

If the annuity income payment is lower than it would have been without smoothing, the Heritage With Profits Fund makes a smoothing gain. If the annuity income payment is higher than it would have been without smoothing, the Heritage With Profits Fund makes a smoothing loss. When we make adjustments for any smoothing, we take account of the gains and losses that the fund has made as a result of smoothing on past payments. The smoothing gains and losses we will allow for are those from payments made since you invested in with profits.

We aim to operate smoothing so that, over time, the total value of all smoothing gains is equal to the total value of all smoothing losses.

5. What expenses do we incur?

Like any other business Standard Life incurs expenses. These include the salaries of our staff, the cost of maintaining our head office and branches, our investment costs, any commission paid to intermediaries and any other ongoing costs. When setting the initial level of annuity income and when calculating the Declared Rate of Return, we make deductions for a fair share of these expenses incurred in the operation of the Heritage With Profits Fund.

6. How we invest the money backing with profits plans

We invest in a mix of assets, including:

- equities (company shares);
- property;
- bonds (loans to governments or companies); and
- cash deposits.

Equity and property assets generally have more variable values than bonds or cash deposits, but over the longer term we expect them to provide higher returns. Bonds and cash deposits generally have more stable values, but over the longer term we expect them to provide lower returns. We may also invest in derivatives – such as investments that provide rights or obligations to buy or sell assets at a particular price and time – as an efficient way of managing our with profits business.

How we decide the asset mix
We regularly review the asset mix that backs each class of with profits business. We seek to optimise investment returns. The asset mix may not be the same for all classes of with profits plan and may change over time.

We decide what asset mix to hold by considering the extent of guarantees for each class of with profits plan, and the appropriate balance between risk and expected return. When we invest in assets with more variable values, there is a higher risk that the assets will have low values when we need to make payments to planholders. The higher the level of guarantees for a class of plan, then the more we may have to invest in lower-risk assets with more stable values, to back that class of plan. However, we generally expect lower-risk assets to give lower returns over the longer term.

Our main restriction on investment strategy is maintaining the financial strength of the Heritage With Profits Fund at an appropriate level whilst meeting our obligations to planholders. The investment return credited to a particular class of with profits plan will reflect the investment return on the mix of assets that backs that class of business.

How we manage the risks associated with investment
Risks associated with investment include companies performing poorly and reducing dividends, or borrowers not making promised interest and capital repayments, or our having to sell assets to meet payouts when prices are depressed. We aim to control our exposure to investment risks by investing in assets of sufficient quality and variety. For example, we set limits on the amount we invest in any one asset, in assets issued by any one company, and in assets that are not traded on a recognised stock or bond market (and so may be difficult to sell).

Sometimes we may need to reduce significantly the proportion invested in higher-risk assets such as equities and property, for example where the financial strength of the Heritage With Profits Fund is reduced following a sudden or sustained fall in asset values. Any change in the asset mix is likely to result in a change in future investment returns and future annuity income payments.

Subject to the above considerations the assets backing with profits plans are held solely for investment reasons.

7. How we manage risk

Running our business inevitably involves some risks. The largest risk is that the investment return on with profits assets is not enough to meet plan guarantees and to maintain the financial strength of the Heritage With Profits Fund. We manage this risk by varying the mix of assets that backs with profits plans.

See section 6 “How we invest the money backing with profits plans

We also manage this risk through the deductions we make for the cost of guarantees when calculating the Declared Rate of Return for With Profits Pension Annuities and payout values for other with profits business. We normally review these deductions once a year, but we may do so more often. We may increase these deductions if we make a loss in respect of guarantees, for example because we assess that the cost of guarantees has increased or will increase. This assessment will vary because of, for example, changes in:

- asset values;
- asset mixes; and
- regular bonus (where applicable).

Other risks include higher-than-expected costs of providing life cover (on plans that have life cover), and higher-than-expected expenses. We may manage these risks through underwriting (for example asking health questions on proposal forms) and reinsurance (passing part of the risk to another insurance company), and through budgetary controls (monitoring expenses and taking action where appropriate).

We carefully consider the significant risks associated with any particular business activity before we undertake it. We take on additional risks in the Heritage With Profits Fund, for example by writing new business, only if these risks are not expected to have a materially adverse effect on existing planholders.

Capital is needed to support any business activity. Before undertaking a business activity in the Heritage With Profits Fund, we compare:

- the expected profitability of the activity; with
- the expected benefits to our with profits planholders of other uses of that capital.

8. What is the inherited estate and how do we use it?

An annuity income payment will only include an inherited estate enhancement if we are making distributions from the inherited estate at the time when we make that payment.

On 10 July 2006 The Standard Life Assurance Company transferred all its UK with profits business into the Heritage With Profits Fund of Standard Life Assurance Limited. This Fund was set up with an inherited estate – a pool of assets that provides working capital for our with profits business. The main role of the inherited estate is to ensure that a prudent amount is retained in the Heritage With Profits Fund for liabilities that may arise in the Fund. To the extent that we are satisfied that the inherited estate exceeds the amount needed for this we will distribute any excess, over time, as an enhancement to annuity income payments.

We aim to restrict any distribution of the inherited estate to with profits investments that have remained continuously in with profits since 9 July 2006.

9. How we manage new business

We aim to offer competitive terms for new business and increases to premiums on existing business. We set limits on the new business that can be written in the Heritage With Profits Fund.

We are not selling new With Profits Pension Annuities. However, we sell other types of with profits plans that do invest in the Heritage With Profits Fund and we have no plans to stop doing so. If we do ever stop selling new with profits plans, we will notify you and will write to explain how we will manage our with profits business in the future.

10. How we balance the interests of with profits planholders and shareholders

Standard Life Assurance Limited is a wholly owned subsidiary of Standard Life plc, which is owned by its shareholders. Shareholders are entitled to certain payments from the Heritage With Profits Fund and meet certain costs, as described below.

We explained earlier how we set Declared Rates of Return and the adjustments we may make to the investment return on the assets we hold to back our With Profits Pension Annuity business. For unitised plans, provided we meet our obligations to planholders, the shareholders are entitled to the deductions (except deductions for tax, where applicable, or costs of guarantees). In return they meet the expenses and any costs of life cover and of critical illness cover on these plans. For conventional plans and With Profits Pension Annuities, the adjustments made (except adjustments for any distribution of any inherited estate) remain in the Heritage With Profits Fund, and this Fund meets the expenses and any cost of life cover on these plans.

We will not take any action to increase the amount shareholders may receive if this would conflict with our duty to treat customers fairly.

The Standard Life Assurance Limited Board makes all the decisions about with profits business. The With Profits Committee independently assesses the fairness to with profits planholders of any significant proposed action or exercise of discretion.

We publish a report to UK with profits planholders each year on our website www.standardlife.co.uk/withprofits. This report sets out the Board's opinion on the fairness to planholders of its exercise of discretion during the previous calendar year. The With Profits Committee may append a report of its own to this report.

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