Scottish Friendly Solvency and Financial Condition Report December 2016

Scottish Friendly

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Summary

Scottish Friendly Assurance Society Limited (Scottish Friendly), which has roots that stretch back to 1862, is a modern financial mutual based in Glasgow. Comprising Scottish Friendly Assurance, Scottish Friendly Asset Managers and Scottish Friendly Insurance Services, the Group develops and administers a range of life and investment products including ISAs. These products are marketed under the Scottish Friendly brand or are “white labelled” by other financial services providers.

Today, as at 31 December 2016, Scottish Friendly Group has assets under management of over £2.9 billion and has 513,000 members. In 2016 Scottish Friendly achieved record results. Total sales increased by 33% to £33.9m APE (the industry standard measure of annual premium equivalent), statutory earned premiums increased to £75.7m. Under the new Solvency II regulations our solvency ratio is 199.3%.

Over the past decade, Scottish Friendly significantly restructured its business, reducing administration costs and maintaining efficient acquisition costs. The Group flourishes through a three-part growth strategy of organic growth, mergers and acquisitions and business process outsourcing.

Since 2012, Scottish Friendly’s organic growth has been founded on the introduction of innovative and affordable ISA investments via the Group’s My Plans platform, including a Junior ISA for children, and a range of protection products. Scottish Friendly has continued to build sales to record levels and increase membership as a result of strong e-business and direct marketing and major collaborations with companies like the BGL Group and Neilson Financial Services.

The addition of transfers of engagements from other firms is a key component of Scottish Friendly’s strategy that produces long term economies of scale. The take-over of Marine & General Mutual in June 2015 was the Group’s biggest transfer to date, more than doubling Scottish Friendly’s assets under management.

This report is the Solvency and Financial Condition Report for Scottish Friendly Assurance Society Limited. It is the first report produced under the new Solvency II regime and is a solo report covering Scottish Friendly Assurance activities.

DIRECTORS' RESPONSIBILITIES STATEMENT IN RESPECT OF THE SOLVENCY AND FINANCIAL CONDITION REPORT ("SFCR")

The Directors are responsible for preparing the Solvency and Financial Condition Report ('SFCR') in accordance with applicable law and regulations.

The PRA Rulebook for Solvency II firms in Rule 6.1(2) and Rule 6.2(1) of the reporting Part requires that Scottish Friendly must have in place a policy of ensuring the ongoing appropriateness of any information disclosed and that Scottish Friendly Assurance Society Limited must ensure that its SFCR is approved by the directors.

Each director certifies that:

(a) the Solvency and Financial Condition Report ("SFCR") has been properly prepared in all material respects in accordance with the PRA rules and Solvency II Regulations;

(b) throughout the financial year in question, the Society has complied in all material respects with the requirements of the PRA rules and Solvency II Regulations as applicable to the Society; and

(c) it is reasonable to believe that, at the date of the publication of the SFCR, the Society has continued so to comply, and will continue so to comply in future.

By order of the Board.

J Galbraith	**N Lovatt**
Director	**Director**
18 May 2017	**18 May 2017**

REPORT OF THE EXTERNAL INDEPENDENT AUDITOR TO THE DIRECTORS OF SCOTTISH FRIENDLY ASSURANCE SOCIETY LIMITED ('SCOTTISH FRIENDLY') PURSUANT TO RULE 4.1 (2) OF THE EXTERNAL AUDIT CHAPTER OF THE PRA RULEBOOK APPLICABLE TO SOLVENCY II FIRMS

Report on the Audit of the relevant elements of the Solvency and Financial Condition Report ("SFCR")

Opinion

Except as stated below, we have audited the following documents prepared by Scottish Friendly as at 31 December 2016:

- the 'Valuation for solvency purposes' and 'Capital Management' sections of the SFCR of Scottish Friendly as at 31 December 2016, ('the Narrative Disclosures subject to audit'); and
- Scottish Friendly's templates S.02.01.02, S.12.01.02, S.23.01.01, S.25.01.21, S.28.01.01 ('the Templates subject to audit').

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the 'relevant elements of the SFCR'.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on the Other Information which comprises:

- the 'Executive summary', 'Business and performance', 'System of governance' and 'Risk profile' elements of the SFCR;
- Scottish Friendly's templates S.05.01.02 and S.05.02.01;
- the written acknowledgement by management of their responsibilities, including for the preparation of the SFCR ('the Responsibility Statement').

In our opinion, the information subject to audit in the relevant elements of the SFCR of Scottish Friendly as at 31 December 2016 is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as modified by relevant supervisory modifications, and as supplemented by supervisory approvals and determinations.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland), and including ISA (UK) 800 and ISA (UK) 805. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report section of our report. We are independent of Scottish Friendly in accordance with the ethical requirements that are relevant to our audit of the SFCR in the UK, including the APB's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusions relating to going concern

We are required by ISAs (UK and Ireland) to report in respect of the following matters where:

- the Directors' use of the going concern basis of accounting in the preparation of the SFCR is not appropriate; or
- the Directors have not disclosed in the SFCR any identified material uncertainties that may cast significant doubt about Scottish Friendly's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the SFCR is authorised for issue.

We have nothing to report in relation to these matters.

Emphasis of Matter – Basis of Accounting

We draw attention to the 'Valuation for solvency purposes' and 'Capital Management' sections of the SFCR, which describe the basis of accounting. The SFCR is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The SFCR is required to be published, and intended users include but are not limited to the PRA. As a result, the SFCR may not be suitable for another purpose. Our opinion is not modified in respect of these matters.

Other Information

The Directors are responsible for the Other Information.

Our opinion on the relevant elements of the SFCR does not cover the Other Information and, we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the SFCR, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the relevant elements of the SFCR, or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the relevant elements of the SFCR or a material misstatement of the Other Information. If, based on the work we have performed, we conclude that there is a material misstatement of this Other Information, we are required to report that fact.

We have nothing to report in this regard.

Responsibilities of Directors for the Solvency and Financial Condition Report

The Directors are responsible for the preparation of the SFCR in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations.

The Directors are also responsible for such internal control as they determine is necessary to enable the preparation of a SFCR that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report

It is our responsibility to form an independent opinion as to whether the relevant elements of the SFCR are prepared, in all material respects, with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

Our objectives are to obtain reasonable assurance about whether the relevant elements of the SFCR are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs (UK and Ireland) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decision making or the judgement of the users taken on the basis of the SFCR.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: https://www.frc.org.uk/auditorsresponsibilities. The same responsibilities apply to the audit of the SFCR.

This report is made solely to the Directors of Scottish Friendly in accordance with Rule 4.1 (2) of the ExternalAudit Chapter of the PRA Rulebook for Solvency II firms. We acknowledge that our report will be provided to the PRA for the use of the PRA solely for the purposes set down by statute and the PRA's rules. Our audit work has been undertaken so that we might state to the insurer's Directors those matters we are required to state to them in an auditor's report on the relevant elements of the SFCR and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than Scottish Friendly and the PRA, for our audit work, for this report or for the opinions we have formed.

Report on Other Legal and Regulatory Requirements.

In accordance with Rule 4.1 (3) of the External Audit Chapter of the PRA Rulebook for Solvency II firms we are required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of Scottish Friendly's statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

We have nothing to report in this regard.

Stephen Williams (Senior Statutory Auditor)

for and on behalf of Deloitte LLP

Chartered Accountants and Statutory Auditor

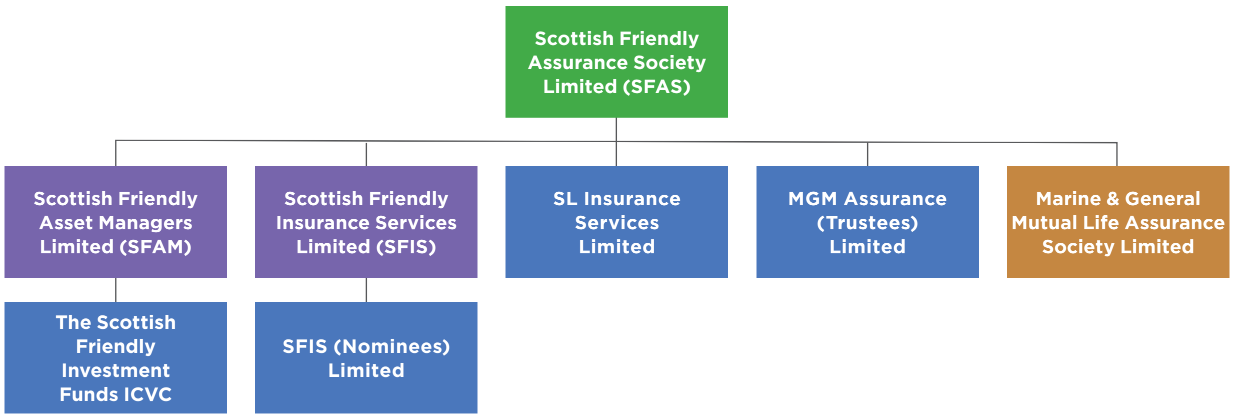
Glasgow, United Kingdom

[Date]

A. Business and Performance

A.1. Business

Scottish Friendly is an incorporated friendly society, a type of mutual, and consequently there are no holders of qualifying holdings in Scottish Friendly. The organisational structure of the business is detailed below.



Green denotes insurance company.
Purple denotes IFPRU firm.
Blue denotes unregulated entity.
Orange denotes application to cancel permissions complete, and is in the process of being struck off.

Scottish Friendly offers a range of life insurance products to policyholders in the United Kingdom. The main products are whole of life policies, endowment assurances, term assurance and ISAs.

The Scottish Friendly balance sheet is split between its Main Fund, which is open to new business, and the Sub Funds, which are closed to new business. The closed funds, are the Rational Shelley sub fund, LANMAS (London Aberdeen and Northern Mutual Assurance Society) sub fund, the Scottish Legal Life sub fund and Marine & General Mutual (M&GM) sub fund.

Small volumes of legacy products were sold across Europe either by Scottish Friendly, Scottish Legal or M&GM and premiums are still received for these.

There have not been any significant events impacting Scottish Friendly over the course of 2016.

Scottish Friendly is authorised and regulated by the Prudential Regulatory Authority (PRA), which is located at 20 Moorgate, London EC2R 6DA.

Scottish Friendly is also regulated by the Financial Conduct Authority (FCA), which is located at 25 The North Colonnade, London E14 5HS.

Scottish Friendly's auditor is Deloitte LLP, whose Glasgow office is 110 Queen Street, Glasgow G1 3BX.

A.2. Underwriting Performance

The following table illustrates Scottish Friendly's performance over 2016, as reflected in the 2016 Annual Report and Accounts:

Technical Account – Long Term Business
For year ended 31 December

	Scottish Friendly	
	2016 £000	2015 £000
Earned Premiums	**75,709**	66,345
Reinsurance Premiums	**(17,063)**	(10,935)
Earned Premiums, Net of Reinsurance	**58,646**	55,410
Investment Income	**90,926**	65,393
Unrealised Gains/(Losses) on Investments	**89,058**	(47,707)
Other Technical Income	**9,722**	3,064
Gain on Transfer of Engagements	**-**	5,118
	248,352	81,278
Claims Incurred	**157,004**	111,463
Reinsurance Claims	**(71,505)**	(43,250)
Net Claims Incurred	**85,499**	68,213
Change in Other Technical Provisions	**106,953**	(24,083)
Operating Expenses	**35,934**	31,455
Exceptional Costs	**-**	2,277
Investment Expenses & Charges	**995**	794
Other Technical Charges	**-**	21
Tax attributable to Long Term Business	**-**	-
Actuarial (Gain)/Loss re pension scheme	**8,426**	(56)
Transfer to/(from) the Fund for Future Appropriations	**10,545**	2,657
	248,352	81,278

Scottish Friendly writes three lines of business as detailed below:

- Insurance with participation (i.e. with-profits business).
- Index Linked and Unit Linked.
- Other Life Insurance.

The table below illustrates Scottish Friendly's premiums, claims and expenses split by Solvency II lines of business for the period ended 31 December 2016.

Period ended 31 December 2016

	Insurance with participation £000	Index Linked & Unit Linked Insurance £000	**Other Life Insurance £000**	Total £000
Gross Premiums	**40,126**	9,842	**25,741**	75,709
Gross Claims	**92,604**	25,106	**39,294**	157,004
Expense	**14,371**	2,352	**20,206**	36,929

A.3. Investment Performance

The return of the asset shares within the Scottish Friendly with-profits fund for 2016 was 14.5% (2015: 2.3%), reflecting a year where markets rose considerably in the second half of the year following the referendum outcome for the UK to leave the EU which boosted the UK stock market. This had the impact of boosting final bonus rates for most with-profits customers as at 31 December 2016 Scottish Friendly's assets under management rose to £2,708 million (2015: £2,510 million).

Financial investments, including derivatives, are recognised at fair value through profit or loss.

Scottish Friendly manages these investments and makes purchase and sale decisions based on their fair value in accordance with Scottish Friendly's investment strategy. Upon initial recognition, attributable transaction costs are recognised in profit or loss as incurred. Financial investments at fair value through profit or loss are measured at fair value and changes therein are recognised in profit or loss.

The following table illustrates Scottish Friendly's investment income over 2016 by asset class, as reflected in the annual report and accounts:

	Scottish Friendly	
	2016 £000	2015 £000
Income from land & buildings	**139**	125
Income from other investments	**34,162**	35,188
Net gains on the realisation of investments	**56,625**	30,136
Net (loss) on pension scheme	**-**	(56)
	90,926	65,393

A.4. Performance of other activities

Other technical income comprises fee income and foreign exchange gains and losses. Fee income is charged to policyholders for administration services, investment management services and surrenders. These fees are recognised in the period over which the services are performed.

In 2016 this totalled £9.7 million compared to £3.1 million in 2015.

A.5. Any other material information

There is no other material information to provide in this report.

B. System of Governance

B.1. General information on the system of governance

As a mutual organisation, the Board of Management is responsible to the members for the performance of Scottish Friendly, and the service that is provided. This accountability is exercised through the Delegates system of member representation.

The Board Members and Scottish Friendly Executives who have duties in relation to Scottish Friendly's subsidiaries are fully responsible for ensuring that they are managed to the same high standards and principles set out by Scottish Friendly.

Responsibilities have been allocated to senior management in accordance with the Senior Insurance Managers Regime (SIMR). The functional structure of Scottish Friendly and roles and responsibiities of key function holders are set out in Appendix F1 and F2.

Scottish Friendly has no shareholders.

Internal Control Framework

The Board is responsible for directing the affairs of Scottish Friendly and its subsidiaries. In addition to the principles of prudent management, there are several specific powers given to the Board, which are defined in the Scottish Friendly Rules.

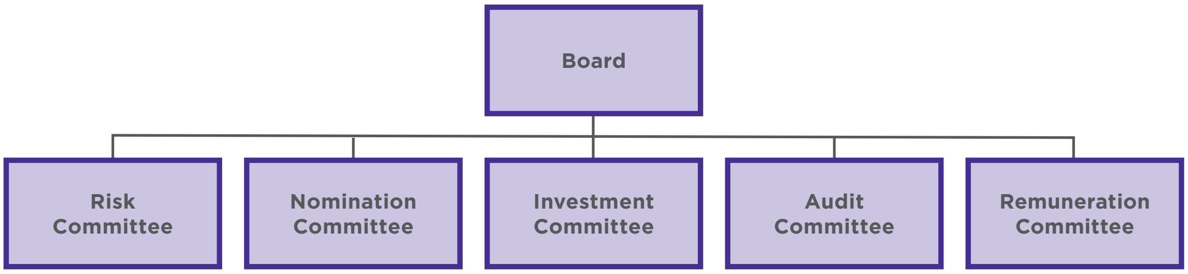
It is impractical for all of these powers to be exercised by the Board in the day-to-day management of Scottish Friendly's affairs, and so a number of them are delegated to the Chief Executive, and by him to other members of Scottish Friendly's staff.

In addition, there are a number of areas where Board Committees have been established, and appropriate powers delegated to them.

Notwithstanding such delegation of powers, the Board retains overall authority for the activities of Scottish Friendly. In particular, in the following areas any changes must be approved by the Board:

- authorisation regime for bank accounts
- changes to investment parameters and deals outwith parameters
- property deals outwith limits
- appointment and remuneration of executives
- new projects
- acquisitions
- Scottish Friendly's budget
- distribution of surpluses and bonuses.

Committee Structure



The committee and governance structure is set out in detail in Appendix F1. The high level structure is set out below and the responsibilities of the Committees are as follows:

Risk Committee

- Provides focused support and advice on risk governance, assisting the Board in reviewing the systems for managing all aspects of business risk.
- Takes account of the most significant issues and risks, both operational and financial, likely to impact on the Group's financial statements.
- Reviews, challenges and approves the revised Risk Appetite Methodology and Statements including monitoring measures with limits and triggers that are the basis for regular Own Risk and Solvency Assessment (ORSA) reporting.
- Shapes the design and content of the Annual ORSA report to meet the requirements of the Board in terms of risk insights and forward-looking threats.
- Receives regular reports from Risk and Compliance teams outlining the key prudential and conduct risks facing Scottish Friendly and the controls and actions in place to mitigate their impacts.

Nomination Committee

- Ensures that plans are in place for orderly succession for appointments to the Board.
- Leads the process for such appointments and makes recommendations to the Board, taking into consideration the time commitments required of Non-Executive directors and their independence.
- Considers the overall balance of skills, experience and knowledge to ensure that Directors bring informed and independent judgement to the Board.
- Ensures that Scottish Friendly's employee policies are applied in Board nomination matters.

Investment Committee

- Oversees Scottish Friendly's investment holdings and performance on behalf of the Board.
- Make decisions on asset allocation and strategy of the Scottish Friendly funds in line with the liabilities, relevant risk appetite and parameters established by the Board or by the relevant fund objective.
- Monitor risk appetite, investment parameters and fund objectives, making recommendations to the Board as appropriate.

Audit Committee

- Review internal control systems, including internal financial controls and ensure that these continue to be effective; advise the Risk Committee as appropriate of any concerns regarding the effectiveness of the current control framework.
- Considers the Audit Plan which highlights key judgement areas and summarises changes in reporting requirements.
- Reviews the annual financial statements and regulatory returns and approves these for submission to the Board.
- Approve the internal audit programmes and receives regular process reports from internal audit and ensures that recommendations made are followed up. Also monitors co-ordination between the internal and external auditors and ensures that the internal audit function is adequately resourced and has appropriate standing within the organisation.
- Assesses the effectiveness of the internal and external audit processes through the reporting that it receives from the respective auditors who are present at each Committee meeting.

Remuneration Committee

- Review the remuneration of the Chairman and determines appropriate levels of Executive Management remuneration.

Remuneration Policy

Scottish Friendly's policy is to provide a competitive remuneration package which will attract and retain the appropriate calibre of Executive and Non-Executive Directors.

Executive Director salaries are reviewed annually by reference to comparable positions in other organisations and any change to salary is effective from 1 January. In reviewing salaries, the Committee takes into account remuneration trends in the financial services sector, as well as considering wider economic influences. The Remuneration Committee ensures that it remains appraised of these factors and of best practice, taking external advice where appropriate.

The remuneration package for Executive Directors incorporates a performance element which is targeted at increasing growth and cost efficiencies, generating longer term value for members. Payments are capped at 60% of salary. The Executive Directors are entitled to a company car and healthcare insurance.

Fees for Non-Executive Directors are monitored and reviewed annually with changes effective from 1 May through approval by the Executive Directors and the Chairman. Fees are designed to recognise the responsibilities of Non-Executive Directors and to attract individuals with the necessary skills and experience to contribute to the future development of Scottish Friendly. Fees are made up of an annual fee covering Board and Committee membership.

Additional fees are payable to the Chairman and Vice-Chairman and to the Chairs of the Audit, Risk, Remuneration and Investment Committees, in respect of the additional responsibilities relating to those roles. Fees for the Chairman are set by the Committee in his absence. Fees are neither performance-related nor pensionable and Non-Executive Directors do not receive any additional benefits.

Non-Executive Directors receive reimbursement of travel and accommodation costs where required for attending meetings.

The aggregate premiums payable for the year by five Directors and five other members of the Executive in respect of Scottish Friendly's products amounted to £23,422 (2015: £17,994).

At the year end, no Director of Scottish Friendly had any beneficial interest in shares of Scottish Friendly's subsidiary companies.

B.2. Fit and Proper

The following section contains more details about Scottish Friendly's "fit and proper" procedures.

When recruiting an individual to perform a controlled function, Scottish Friendly takes appropriate steps to obtain sufficient information about a candidate's previous relevant activities and training. Criteria to assess competence will be established and a role profile developed to measure their suitability, competence and performance against the role requirements.

When making an offer of employment, Scottish Friendly will issue the following:

- a questionnaire (to establish the fitness and propriety of the candidate);
- a statement of their regulatory responsibility and a guide to being an approved person; and
- the Statements of Principle and the Code of Conduct for Approved Persons.

The Compliance Officer will submit an approved person application to the relevant regulator (depending on the controlled function) before the activities requiring approval commence. Applications will always be completed fully and honestly. The regulator will grant/approve an application only if they are satisfied that the candidate is a fit and proper person to perform the controlled function stated on the application.

Responsibility for ensuring that the candidate is fit and proper remains with Scottish Friendly.

Scottish Friendly requires all Approved Persons to provide evidence of their on-going fitness and propriety. This is completed as part of the annual appraisal process and is assessed following the completion of questionnaire by the individual which is then reviewed by the Chief Executive. When assessing fitness and propriety, the following are considered:-

- Honesty, integrity and reputation;
- Competence and capability; and
- Financial soundness.

B.3. Risk Management System

The Role of Risk Management

Scottish Friendly considers risk management to be fundamental to good management practice and a significant aspect of corporate governance. Effective management of risk provides an essential contribution towards the achievement of strategic and operational objectives. Risk management is an integral part of Scottish Friendly's routine decision making and management activity and is incorporated within the strategic and operational planning processes at all levels throughout the business.

Risk Management Framework

Scottish Friendly maintains a Risk Management Framework ("RMF"), which sets out how risk management operates throughout the business and how it is linked to Risk Appetite and Risk Policies, the strategy, the business and Solvency and Capital Management.

The key objective of the RMF is to ensure that Scottish Friendly has a sound and consistent basis for identifying, measuring, controlling, monitoring and reporting risk at all levels. The articulation of the Risk Appetite Statements and associated Key Risk Indicators is an important activity for creating an effective RMF across the business. This sets out the level of risk Scottish Friendly is willing to take in pursuit of the strategy and the measures that will be used to monitor the exposures on an ongoing basis across all risk categories.

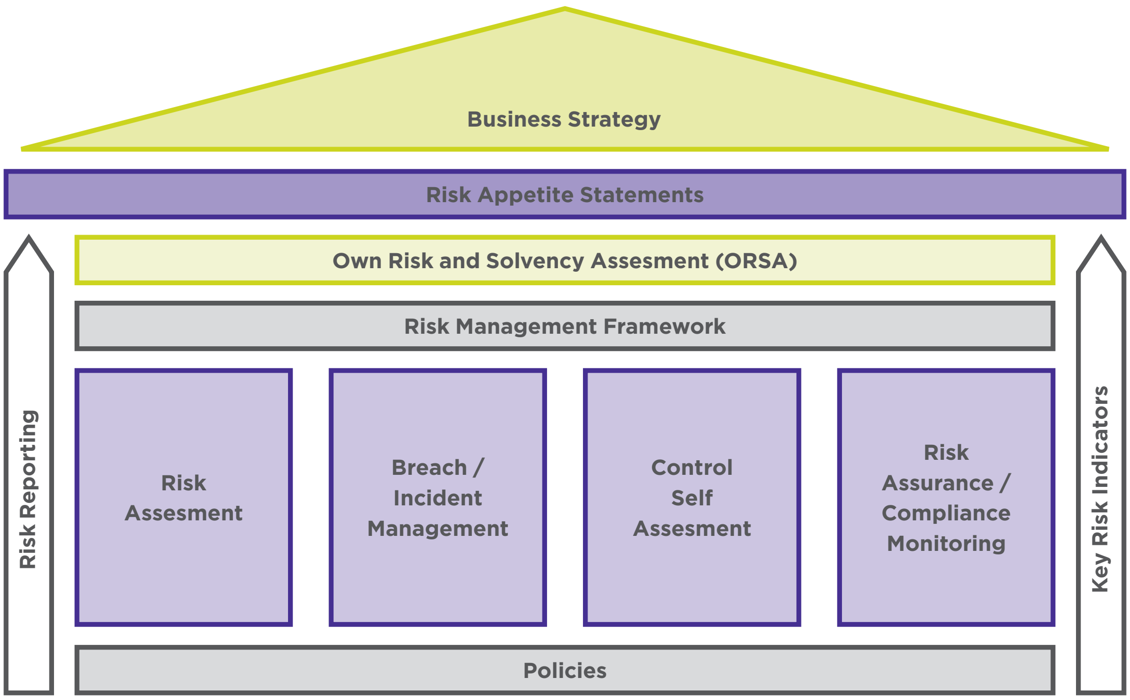
The RMF is integrated with the Solvency and Capital Management activity, in particular the ORSA. The ORSA considers the risks arising from the agreed strategic priorities, how much capital is needed to protect the business against those risks and how resilient the Scottish Friendly business model is under stressed conditions. The ORSA is a key risk management tool and is actively used by senior management and the Board to inform decision making.

The aim of the RMF is to ensure that Scottish Friendly stakeholders understand the key risks facing the business both in the near and long-term and how these risks are managed, reflecting the Risk Appetite and tolerances that have been approved by the Board.

Key components of Risk Management Framework

The Risk Management Framework (RMF), sets out a coherent and proactive set of arrangements and processes designed to support the effective management of risk throughout the business. The RMF encompasses Scottish Friendly Insurance Services Limited and Scottish Friendly Asset Management Limited.

The components of the RMF are shown below.



The outputs from the RMF provide assurance that risks are being appropriately identified and managed. An independent assessment of management's approach to risk management is being performed by Risk, Compliance and Internal Audit.

Risk Register

Scottish Friendly maintains a suite of risk registers, which document the key risks to Scottish Friendly. The risk registers categorise risks at 3 levels appropriate to the characteristic of the risk. At the highest level, Level 1 risks include Strategic, Operational, Financial Soundness, Market, Underwriting, Credit and Conduct. Each risk category is allocated an Executive Owner.

Risk Appetite Statements

Risk Appetite Statements (RAS) have been articulated for each category of risk. They describe the amount of risk that Scottish Friendly is willing to take for each risk category. These are based on a consideration of the implications of the current strategy and the risks that are created in pursuit of the objectives. They are approved by the Board after being reviewed by the Executive and the Risk Committee. The RAS are the link between the strategic objectives of the Society and the RMF.

Risk policies

Risk policies are in place for each Level 1 or where required, Level 2 risk categories. These define the principles and standards for managing key risks across the business. Each policy has been allocated an Executive Owner who is responsible for ensuring compliance with the standards across the Society on an ongoing basis.

Key Risk Indicators

For each risk category, Key Risk Indicators and associated metrics have been developed and agreed. These enable risk to be measured on an ongoing basis against agreed appetite.

This is presented on the ORSA Dashboard and is produced quarterly for the Executive Risk Committee and the Risk Committee.

An incident or breach of a trigger is brought to the attention of the relevant Executive Owner and the Head of Risk for consideration of any actions required. Breaches of a limit that are generally more serious are escalated to the Executive Owner, Head of Risk and Chief Executive for immediate consideration of actions required. Depending on the nature of the breach, the Board and/or regulators would also be informed. Regulatory breaches and incidents are recorded and reported to the monthly Executive meeting for discussion.

Control Self-Assessment (CSA)

Control Self-Assessment (CSA) is an ongoing process for monitoring and managing inherent and residual risk exposures. On a quarterly basis the Executive Risk Owner for each department is required to formally document the output of the process and attest to the residual risk exposure against the agreed risk appetite. A key element of the CSA process is the identification of risks and the management of risk through the assessment of the performance of key controls. This process is performed at both a departmental and at corporate wide level via the Corporate Risk Register. The assessment of inherent and residual risk is rated using an agreed risk scoring matrix.

Own Risk and Solvency Assessment (ORSA)

The Own Risk and Solvency Assessment (ORSA) is an integral part of the strategic decision making process within Scottish Friendly and its results inform capital management, investment and product development decisions taken by the Executive and the Board. As well as this, the ORSA creates a link between the risks that are being taken to deliver the strategy, and the capital implications that arise.

A key purpose of the ORSA process and report is to assess the short, medium and long term risks that arise as a result of the strategic priorities of Scottish Friendly, and to consider how the risks are managed, how much capital is required to protect the business against those risks and how resilient the business is under a variety of stress scenarios.

The full ORSA report is produced annually or more frequently should there be a significant change to the risk profile of the business. The Board approved ORSA report is sent to the PRA.

Scottish Friendly has a Board approved ORSA Policy that focuses on the processes and procedures for the ORSA framework, including roles and responsibilities.

Oversight of Risk Management Framework

The Risk and Compliance Function oversees and monitors Scottish Friendly's compliance with relevant regulation and provides assurance that Scottish Friendly is managing risks in accordance with the requirements of the RMF, agreed Risk Policies and the Compliance manual.

Risk governance

Scottish Friendly adopts the 'Three Lines of Defence' model to define the roles and responsibilities for risk management throughout the organisation.

- The First Line of Defence is represented by the operational areas across Scottish Friendly which are responsible for the identification and management of day-to-day risks and controls across the business. The management and monitoring of risks are the responsibility of each Executive owner.

- The Second Line of Defence is represented by the Committees and control functions that provide ongoing oversight and challenge of the risk exposures and internal control environment. The Risk and Compliance functions provide independent challenge and oversight of each business function, led by a designated Executive Head of Risk. Primary activities include compliance monitoring reviews and reviews of risk and control self-assessments.
- Internal Audit provides the Third Line of Defence by delivering a cyclical and prioritised programme of risk based audits covering all aspects of work undertaken in the First and Second Line business areas over a period of years. Internal Audit may take some assurance from the work of the Second Line functions to reduce or tailor its checking of the First Line operations.

The overall responsibility for risk within the business ultimately rests with the Board. Some responsibilities have been delegated to the Audit Committee, to assist the Board in reviewing the systems of internal controls and the external financial reports of the business, and the Risk Committee, to provide focused support and advice on risk governance and to assist the Board in reviewing the systems for managing all aspects of business risk, including operational, prudential, conduct and strategic risks.

In addition, the Executive Risk Committee (ERC) is the primary forum for Executive oversight and challenge of the risk and control environment across the business and is chaired by the Head of Risk. All Executives are responsible for the identification, assessment, management and control of risks in their respective areas, delegating such parts of this responsibility to appropriate managers or other individuals where practical and are required to report on their respective area at the ERC on at least a quarterly basis.

Risk management is embedded in the duties and responsibilities of all employees and it is the responsibility of managers to ensure that this approach is maintained, and the responsibility of the ERC to ensure that this is effectively monitored. The Corporate Risk Register is reviewed by the Risk Committee quarterly. This sets out the key strategic, conduct and operational risks facing Scottish Friendly, the likelihood of occurrence and the potential impact.

The Board has overall responsibility for the system of internal control and, through a combination of the above activities, is able to review its effectiveness annually, including financial, operational and compliance controls and risk management systems. Its effectiveness has also been reviewed by the Board specifically for the purposes of this statement.

B.4. Internal Audit

The following provides more information about Scottish Friendly's Internal Audit Function:

The Internal Audit Function (IAF) has the objective of providing management and the Audit Committee (AC) with an independent assessment of the effectiveness of internal control systems in the areas outlined and agreed in the Internal Audit Plan.

The Internal Audit Plan is prepared annually and approved by the Audit Committee. All internal audit reports are presented to the Audit Committee.

Fundamental Principles under Solvency II (Articles 47 and 50)

Scottish Friendly incorporates the IAF and associated reporting lines into the organisational structure in a way that ensures that the IAF is free from influences that may compromise the IAF's ability to undertake its duties in an objective, fair and independent manner. The persons carrying out the IAF shall not assume any responsibility for any other function.

The IAF shall operate under the ultimate responsibility of, and report to the AC and shall, where appropriate, cooperate with other functions in carrying out their roles.

The persons carrying out the IAF shall have the necessary authority, resources and expertise to carry out their responsibilities. They shall also have unrestricted access to all relevant information necessary to carry out their responsibilities. The persons performing the IAF shall promptly report any major problem in their area of responsibility to the AC or Board.

The IAF shall:

- establish, implement and maintain an audit plan setting out the audit work to be undertaken, taking into account all activities and the complete system of governance of Scottish Friendly;
- take a risk-based approach in deciding its priorities;
- report the audit plan to the AC;
- issue recommendations based on the work carried out and submit a written report on its findings and recommendations;
- verify compliance with the decisions taken by the AC on the basis of those recommendations.

Where necessary, the IAF may carry out audits which are not included in the audit plan.

Relationship with Management/Other Stakeholders

IAF has a dual reporting role to Management for assistance and support in organising and conducting assignments, and to the AC for strategic direction and accountability. IAF will take account of the activities of external audit and external audit will review the planned activities of internal audit to assess the scope and relevance of the work to the external audit activity. This will facilitate a "joined up" approach where it is appropriate to do so.

Internal audit cannot absolve management of responsibility for internal controls and must ensure it is not involved in the operation of controls.

IAF Process

Internal audit will produce a proposed schedule of audits to be performed during the year, to be submitted to the AC for approval.

At the conclusion of each element of the Internal Audit plan a draft report will be prepared. Auditees will be required to consider their element of the report for factual accuracy and to provide management responses for considering the recommendations, and where applicable, realistic target dates for implementation. Final reports will then be issued to auditees, the Executive Team and the AC.

B.5. Actuarial Function

Scottish Friendly's actuarial function has the following responsibilities:

Chief Actuary, responsible for taking all reasonable steps to ensure the continued solvency, safety and soundness of Scottish Friendly, including actuarial investigations and regular valuations on the Solvency II and statutory reporting bases.

Undertaking the capital calculations, and ensuring adequate provisions are available to meet policyholder benefits in all reasonable foreseeable circumstances in accordance with the risk appetite and taking due account of liquidity.

Ensuring that the premium rates being charged for new business are appropriate to enable Scottish Friendly in due course to meet its emerging liabilities.

Ensuring regulatory and legislative requirements are met, including annual review of operation Principles and Practices of Financial Management (PPFM).

Undertaking regular and ad hoc exercises including bonus investigations, calculations, reviews, analyses, profitability and experience monitoring, reinsurance arrangements, reports and regulatory submissions as required from time to time.

Assisting in the Product Development processes. For example market research, product design, profit testing, specification and appropriate reinsurance arrangements.

Specifying and implementing claims calculations bases and methods including monitoring and the application of Market Value Adjustments (MVAs) as and when required.

B.6. Outsourcing

Outsourcer Failure/Replacement risk is defined as failure of outsourcing or supplier arrangements and failures within the administration undertaken by partners, including breach of contract.

Scottish Friendly seeks to manage its exposure to Outsourcer Failure/Replacement risk by establishing minimum control standards and supporting practices/procedures that align with the agreed priorities. The principles seek to provide effective oversight controls to monitor the delivery of the services provided by outsourcers, suppliers and partners ensures that appropriate action is taken to address any issues identified.

The following key outsourced functions are considered critical and important in terms of article 49(2) of the Directive and SOLPRU.

- Internal Audit (EY)
- With Profits Actuary (Oxford Actuaries and Consultants)

In addition there are three distribution contracts which involve an element of policy administration (BGL Group, Neilson Financial Services and Nucleus) and one investment management agreement (Blackrock).

B.7. Other Information

There is no other material information to disclose in this section.

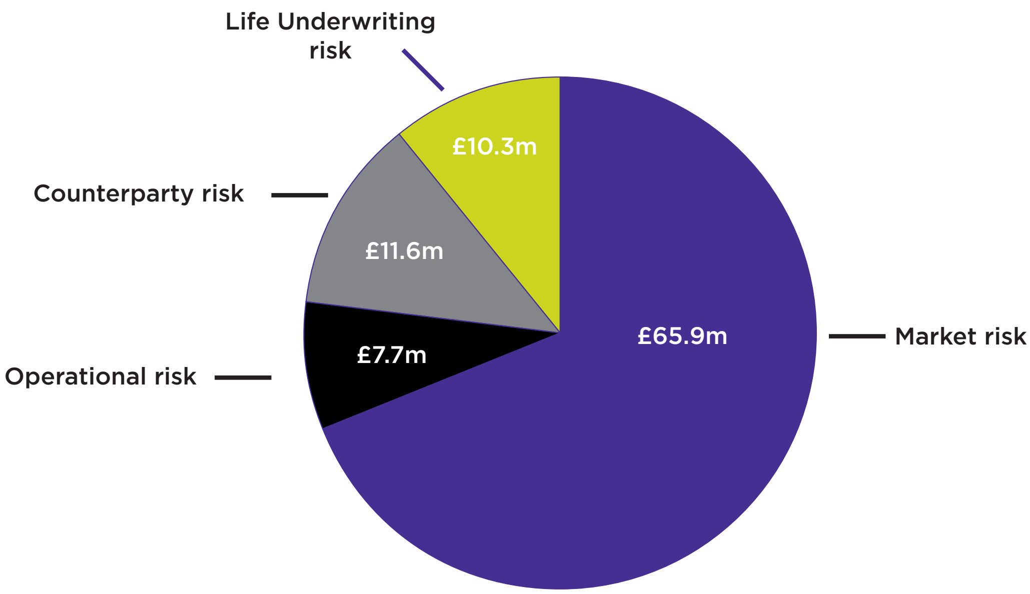
C. Risk Profile

The key risks facing Scottish Friendly are considered within the Own Risk and Solvency Assessment (ORSA) and presented to the Board on at least an annual basis.

Quarterly ORSA Dashboard reports are presented to the Executive Risk Committee, Risk Committee and Board to highlight any significant movements in the risk profile of the business or the forward-looking risks.

The principal risks to which Scottish Friendly is exposed are underwriting, market, credit, and operational risks. These risks are an integral component of the Scottish Friendly's Risk Management Framework (RMF). The RMF supports the indentification, measurement, management, monitoring and reporting of these risks.

Scottish Friendly's Solvency Capital Requirement is calculated using the standard formula and the basic standard formula capital requirement for these risks are shown below:



C.1. Life Underwriting Risk

Underwriting risk is the risk of potential losses arising from inaccurate assessment of the risks entailed in writing an insurance policy. This is mitigated by the provision of reinsurance arrangements and limits on cover and explicit exclusions.

As at 31 December 2016 the total capital required in respect of underwriting risk facing the business was £10.3m. This is comprised of the following risks across each of the sub funds.

Business block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Aggregate £m
Mortality	-	-	-	-	-	-
Longevity	0.5	-	-	-	1.8	2.3
Disability	-	-	-	-	-	-
Lapse	3.7	-	-	-	-	3.7
Expense	4.9	-	-	-	1.1	6.0
Revision	0.2	-	-	-	0.5	0.7
Catastrophe risk	-	-	-	-	-	-
Diversification	(1.6)	-	-	-	(0.8)	(2.4)
Total life underwriting risk	7.7	-	-	-	2.6	10.3

C.2. Market Risk

Market risk is the risk of adverse financial impact due to changes in fair values or future cash flows from fluctuations in interest rates, foreign currency exchange rates, equity prices and property values. This is mitigated through ongoing solvency monitoring and oversight provided by the Investment Committee.

As at 31 December 2016 the total capital required in respect of market risk facing the business was £65.9m. This is comprised of the following risks across each of the sub funds.

Business block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Aggregate £m
Interest rate risk	-	-	-	-	14.9	14.9
Equity risk	2.8	-	-	0.5	45.6	48.9
Property risk	0.3	-	-	-	1.7	2.0
Spread risk	0.2	-	-	-	7.4	7.6
Currency risk	-	-	-	-	1.6	1.6
Other market risk	-	-	-	-	-	-
Diversification	(0.1)	-	-	-	(9.0)	(9.1)
Total market risk	3.2	-	-	0.5	62.3	65.9

The primary driver of Market risk is 'equity risk' reflecting the investment in equities in respect of the with-profits asset shares, and the impact on the cost of guarantees for that business in the event of a fall in market values.

C.3. Counterparty Default Risk

Credit risk is the risk of financial loss as a result of the default or failure of third parties to meet their obligations. This is mitigated via diversified counterparties and minimum counterparty credit ratings when establishing new relationships.

As at 31 December 2016 the total capital required in respect of credit risk facing the business was £11.6m. This is comprised of the following risks across each of the sub funds.

Business block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Aggregate £m
Type 1	7.5	-	-	0.8	2.9	11.2
Type 2	0.5	-	-	-	-	0.5
Diversification	(0.1)	-	-	-	-	(0.1)
Total counterparty risk	7.9	-	-	0.8	2.9	11.6

Note:

- Type 1 details the exposures to instituitions with credit ratings.
- Type 2 details all remaining exposures.

The primary driver of Credit risk refers to the risks that reinsurers or banks are unable to satisfy their obligations and cause financial loss. Only high quality counterparties are sought as counterparties and concentration risk is managed by using a number of banks and reinsurers to spread the risks.

C.4. Liquidity Risk

Liquidity risk is the risk that loss or adverse circumstances will result in the inability of Scottish Friendly to meet its liabilities when they fall due.

Liquidity risk is subject to extensive management oversight and reporting. Premium and claims analysis is performed by Finance with input from Actuarial and monitored via the Liquidity Cash Resources metric within the ORSA Dashboard, which monitors the cash available versus net cash outflows over the next 3 months.

Reinsurance claims payments and schedules are subject to regular monitoring and any issues raised at regular relationship management meetings. The Investment Committee provides oversight of the asset allocation and ultimately maintains a strategy that includes a proportion of the portfolio that is very liquid e.g. listed equities, gilts, which if required, could be sold to provide additional liquidity during stressed periods.

As at 31 December 2016 the standard formula did not require Scottish Friendly to hold any capital for this risk.

C.5. Operational Risk

Operational risk is the risk of loss or adverse consequences for the business resulting from inadequate or failed internal processes, people or systems, in particular cyber risk, or from external events. This is mitigated through effective first line of defence controls within procedures and where appropriate automated processes.

The Operational Risk capital requirement is calculated in line with the prescribed Standard Formula basis, with the results shown below. The capital requirement is a variable of the earned premiums and the expenses on unit linked business.

As at 31 December 2016 the total capital required in respect of operational risk facing the business was £7.7m. This is comprised of the following risks across each of the sub funds.

Business block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Aggregate £m
Total operational risk	2.8	0.0	0.0	0.3	4.6	7.7

C.6. Risk Sensitivities

Scottish Friendly conducts various stress tests to assess the implications of various scenarios on the capital position of the business. These are completed as part of the ORSA process which is completed at the same time as the Strategic Planning process in Q3. Overall the exercise concludes that under a number of financial scenarios, Scottish Friendly remains well capitalised with capital in excess of the SCR and also within internal Risk Appetite measures.

The following stress scenarios were defined and developed following input from both the Executive and Board:

- Bank of England anchor scenario
- TR16/2 leads to radical back book review
- Restrictions on direct selling
- Key reinsurer downgrade
- Cyber attack.

The scenarios consider the immediate impact to the capital position e.g. payment of remediation and costs, as well as the longer term impact on revenues e.g. cyber-attack impacting ongoing sales volumes. The exercise concludes that under a number of adverse scenarios, Scottish Friendly remains very well capitalised with capital in excess of the SCR and also within internal Risk Appetite measures.

Additional management actions, beyond those modelled already in the SCR calculation, have not been required to be incorporated, as the solvency position does not necessitate the use of the actions to maintain solvency.

In addition to the above reverse stress tests are also completed by the business based on input from the Executive and the Board.

C.7. Other Risks

There are no other material risks not already allowed for in the above sections.

D. Valuation for Solvency Purposes

Valuation Basis

The Solvency II Directive requires Scottish Friendly's assets and liabilities, other than Technical Provisions to be measured at fair value i.e. in accordance with the principles of an arms length transaction between knowledgeable willing parties using market consistent valuation methods.

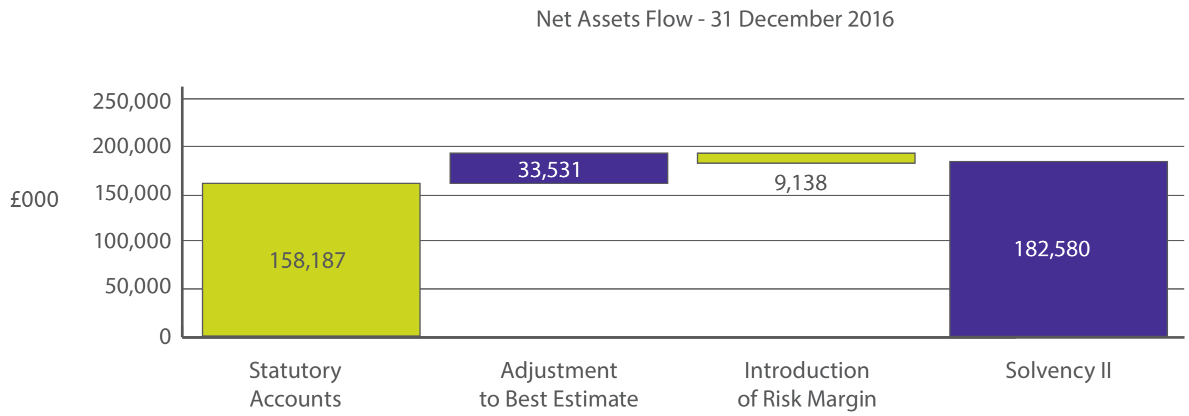
The differences between the Statutory Accounts and Solvency II Balance Sheet at 31 December 2016 are shown below. As the statutory accounts are principally valued at fair value the primary differences between the Solvency II Balance Sheet and the Statutory Accounts are due to the changes in the valuation of the Technical Provisions and associated reinsurance. This is caused by moving to a best estimate approach under Solvency II along with the inclusion of a risk margin as per the Solvency II regulations.

Other differences are either due to the reclassification of assets from one asset sector to another (with no change on the value of the balance sheet). At the 31 December 2016 no material reclassifications were required.

The differences between the Statutory Accounts and Solvency II Balance Sheet are shown below.

	Statutory Accounts £000	Solvency II Adjustments £000	Solvency II Balance Sheet £000
Property & Equipment	3,674	-	3,674
Investments	1,372,471	-	1,372,471
Reinsurance	1,135,282	(155,597)	979,685
Cash	176,511	-	176,511
Other	20,078	-	20,078
Total Assets	**2,708,016**	**(155,597)**	**2,552,419**
Technical Provisions	(2,447,206)	179,990	(2,267,216)
Other	(102,623)	-	(102,623)
Total Liabilities	**(2,549,829)**	**179,990**	**(2,369,839)**
Net Assets	**158,187**	**24,393**	**182,580**

The overall net changes are shown in the chart below.



D.1. Assets Valuation

The approach used to value assets is set out below. Assets are valued at fair value as at the balance sheet date of 31 December 2016.

Property, plant and equipment

Land and buildings are valued at fair value. This is the same basis as the Statutory Accounts for Solvency II purposes. A formal valuation, completed by a fully professional independent valuer, is completed every three years with the next scheduled to take place 31 December 2018.

Plant and equipment are valued at their net realisable value. This is considered by management as an appropriate proxy for fair value of these assets.

Investments

Financial investments are valued at fair value in both the Statutory Accounts and Solvency II balance sheet. As such no valuation adjustments arise between the two bases.

Investments including those held to cover linked liabilities are stated at the current market value as described below:

- Shares and other variable-yield securities and units in unit trusts and OEICs are shown in the balance sheet at mid-market value at the balance sheet date.
- Debt securities and other fixed income securities are valued at the current market value at the balance sheet date.
- Investments in Group undertakings (detailed as Participations under Solvency II) are valued at the net asset value which the Directors believe is a fair proxy for fair value.

Scottish Friendly applies the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

Level 1: unadjusted prices quoted in active markets for identical assets or liabilities.

Prices are obtained from pricing service providers where there is clear evidence that the valuations are based on traded prices in an active market. The prices for assets in this category are received daily from Thomson Reuters, or are provided by third parties based on active market prices.

Level 2: inputs other than quoted prices that are observable either directly (as prices) or indirectly (as derived from prices).

Where it is not possible to determine prices based on actual transactions in an active market, the fair value is based on broker quotes and information from fund managers. Assets in this category include the investment property held by Scottish Friendly and derivatives.

Level 3: the inputs are not based on observable market data (unobservable inputs).

In a minority of cases there are no market observable inputs and therefore the fair value is determined using a valuation technique based on assumptions that are not supported by observable market transactions nor based on market data. Such assets include Scottish Friendly's investment in private equity funds and the subsidiary companies. Each financial instrument is categorised according to the lowest level of input that is significant to the fair value measurement of the financial instrument. Both price volatility and market information on assets are reviewed periodically to see if there is any indicator that an asset may require reclassification due to illiquidity or impairment.

As at 31 December 2016 the following investments were held by Scottish Friendly:

	Scottish Friendly			
	Level 1 £000	Level 2 £000	Level 3 £000	**Total £000**
Financial instrument assets 2016				
Financial investments designated at fair value;				
Shares, other variable yield securities and units in OEICs and unit trusts	1,184,727	982	–	**1,185,709**
Debt securities and other fixed income securities	137,154	–	2,923	**140,077**
Private equity investments	–	–	448	**448**
Participations	–	–	4,528	**4,528**
	1,321,881	982	7,899	**1,330,762**
Derivative assets	–	4	–	**4**
Financial assets measured at fair value through profit and loss	1,321,881	986	7,899	**1,330,766**
Loans and receivables;				
Deposits with credit institutions	–	–	–	**41,583**
Loans secured by mortgages	–	–	–	**86**
Policyholder loans	–	–	–	**36**
	–	–	–	**41,705**
Total financial assets	–	–	–	**1,372,471**

Reinsurance Assets

The recoverables from reinsurance contracts relate to annuity business, which is almost entirely reinsured, and term assurance business, of which a large proportion is reinsured. Both sets of reinsurance arrangements involve a number of different reinsurers. Regular monitoring is carried out to assess the ongoing risk associated with these arrangements.

The reinsurance assets for Solvency II reporting have been calculated on best estimate basis in line with Solvency II requirements, whereas the reinsurance assets for the Statutory Accounts have been calculated on the same basis used at 31 December 2015, which is in line with the previous regulatory regime. The adoption of the Solvency II basis results in a reduction of the overall reinsurance asset of £155.6m.

Cash and Cash Equivalents

Cash and cash equivalents comprise cash at bank and cash in hand as well as short-term deposits with a maturity of three months or less and known redemption values which are held to manage short-term operational cash requirements on origination. They are valued at market value.

Other Assets

These include sundry debtors and prepayments and are valued at fair value in both the accounts and Solvency II.

D.2. Technical Provisions

The technical provisions represent the best estimate of the liability to future policyholders along with a risk margin detailed in the section 'Differences between Solvency II and Statutory Accounting Basis'. The key demographic assumptions in the realistic basis (expense, mortality, morbidity and persistency) are based on the experience investigations carried out in late 2016 and which were presented to the Board in December 2016. The economic assumptions in the realistic basis (e.g. yield curves and volatilities) are based on relevant market data at 31 December 2016.

The key components of the technical provisions are the with-profit benefit reserves, the cost of guarantees, non-profit reserves, unit linked reserves and risk margin. The with-profit benefits reserves (i.e. the asset share for with profits business) may be calculated using a retrospective or prospective approach.

The retrospective approach involves rolling the asset share forward month-on-month allowing for premiums, investment returns, charges and any other relevant factors.

The prospective approach involves discounting the expected payout to policyholders (including allowance for future bonuses) to the valuation date, allowing for future expenses and premiums.

The with-profits benefit reserves at 31 December 2016 are all valued using a retrospective approach except for the Rational Shelley and Scottish Legal business, which are valued using a prospective approach – these business blocks account for around 5% of the total with-profits benefit reserve.

The with-profit benefit reserves on Rational Shelley policies were originally calculated using a prospective approach because it wasn't possible to undertake a retrospective valuation as there was no historic asset share information available when the business was acquired. The asset shares are recalibrated every six months to ensure that they remain appropriate.

The asset shares for the Scottish Legal sub-fund were recalibrated using a prospective approach at 31 December 2016 to ensure that policyholders continue to receive fair payouts on claim as the surplus, which was material ahead of the recalibration exercise, runs off.

Differences between Solvency II and Statutory Accounting Basis

The technical provisions for the statutory accounts have been prepared on the same basis as the technical provisions for Solvency II reporting, with the following changes:

- The Solvency II technical provisions include a risk margin, which is not included in the technical provisions for the statutory accounts. The risk margin is intended to reflect the difference between the amount which must be paid to another insurer to meet the future obligations for a block of policies and the best estimate value of liabilities for the same block of policies.

- The technical provisions for the statutory accounts include allowance for the surplus in the sub-funds, whereas the Solvency II technical provisions do not include these.
- The Solvency II technical provisions make allowance for contract boundaries, whereas no allowance for contract boundaries is made in the technical provisions for the statutory accounts.
- The yield curve for the Solvency II technical provisions is provided by European Insurance and Occupational pensions Authority (EIOPA), whereas the yield curve for the technical provisions in the statutory accounts is provided by the Bank of England (BoE) and the European Central Bank (ECB).

The impact of the differences are shown below:

	Solvency II £000	Statutory Accounts £000
Best Estimate Liabilities	2,258,078	–
Risk Margin	9,138	–
Technical Provisions	2,267,216	2,447,206

D.3. Uncertainties within the Technical Provisions

The basis items with the largest impact on the overall valuation of Technical Provisions are the assumptions surrounding the yield curves, the realistic discount rate and the expense basis.

D.4. Other Liabilities

The other liabilities included in Scottish Friendly's solvency calculation relate mainly to creditors, accruals and deferred income. These are valued at fair value in both the Statutory Account and Solvency II.

The total amount of other liabilities is £102.6m. The key liabilities within this total are detailed in the table below:

	Solvency II £000	Statutory Accounts £000
Deposits from reinsurers	51,930	51,930
Outstanding claims	22,115	22,115
Payable (trade)	11,104	11,104
Pension Benefits	7,337	7,337
Other	10,137	10,137
Total	102,623	102,623

D.5. Alternative Valuation Methods

As there are no alternative valuation methods for Scottish Friendly's holdings in loans and receivables and property, plant and equipment, alternative valuation methods, as detailed in D.1., are used to determine the fair value of these assets.

D.6. Other Material Information

The information presented in section D provides a true and fair view of the valuation for Solvency purposes of Scottish Friendly.

E. Capital Management

E.1. Own Funds

Scottish Friendly's capital management objectives are:

- to protect Scottish Friendly's financial strength, providing security to policyholders,
- to comply with the PRA's capital requirements, Scottish Friendly has not breached these requirements at any point in the current or prior year,
- to enable smoothing of investment returns and payouts, and
- to ensure that Scottish Friendly's capital position is sufficient to enable it to invest in the development of the business in order to fulfil its core strategic objectives as determined by the Board.

The capital position of Scottish Friendly is monitored on a regular basis by the Risk Committee as part of the Risk Management Framework and reviewed formally by the Board.

Scottish Friendly capital comprises of its Own Funds. As a mutual these comprise 100% of the profits not yet allocated to members. As such all capital is Tier 1 capital and there are no restrictions on the availability of these to support either the Minimum Capital Requirement (MCR) or Solvency Capital Requirement (SCR).

The difference between net assets as shown in the financial statements and the Solvency II value of excess assets over liabilities is shown below.

Reconciliation to statutory accounts	£000
Net assets per Statutory Accounts	158,187
Move to best estimate	33,531
Introduction of Risk Margin	(9,138)
Excess of assets over liabilities	182,580

Ring Fenced Funds

The Solvency II excess of assets over liabilities are reduced to reflect the impact of ring fencing of individual sub funds. The sub funds are closed to new business and they have separate equity backing mixes resulting in different investment experiences and bonus policies. The excess assets over liabilities in the sub fund are not treated as transferable.

The impact of this on the Own Funds position is shown below. These sub funds are the Rational Shelley sub fund, LANMAS (London, Aberdeen and Nothern Mutual Assurance Society) sub fund, the Scottish Legal sub fund and the M&GM sub fund.

	£000
Excess assets over liabilities	182,580
Adjustment for restrictions due to ring fencing	(19,635)
Own Funds	162,945

E.2. Solvency Capital Requirement and Minimum Capital Requirement

Scottish Friendly uses the Standard Formula as the basis for calculating capital requirements having reviewed them and assessed them as appropriate for the firm. Scottish Friendly has set out to fully comply with the Standard Formula calculation of both MCR and SCR. We are not aware of any deliberate non-compliance.

The capital position of the business is calculated on a monthly basis and results communicated to the Board. The Risk Committee reviews solvency by risk indicators and the stockmarket is continuously monitored with solvency assessed if volatility triggers are breached.

The Own Funds are summarised below with more detail provided in the Appendices which contain the relevant Quantitative Reporting Templates.

	Solvency II £000
Own Funds	162,945
Minimum Capital Requirement	28,627
Solvency Capital Requirement	81,764
Solvency Ratio	199.3%

Solvency Capital Requirement split by risk modules

The table below shows the risk modules that make up Scottish Friendly's SCR at 31 December 2016.

	Net SCR £000
Market risk	65,920
Life Underwriting	10,345
Counterparty Default Risk	11,604
Undiversified BSCR	**87,869**
Diversification Credit	(14,585)
Basic SCR	**73,284**
Operational Risk	7,784
Adjustment due to RFF/MAP	5,246
Loss-absorbing capacity of technical provisions	(4,550)
Solvency Capital Requirement	**81,764**

The components of these risk modules are shown in section C of this report.

The calculation of Scottish Friendly's Solvency Capital Requirement has been carried out using the parameters of the standard formula. No simplification has been applied to the calculation of the Solvency Capital Requirement.

No capital add-on has been applied to the Solvency Capital Requirement calculated by Scottish Friendly.

Minimum Capital Requirement

The Minimum Capital Requirement has been calculated as the minimum of 45% of the Solvency Capital Requirement and the greater of 25% of the Solvency Capital Requirement and the linearly derived Minimum Capital Requirement.

The detail of the MCR calculation is shown below:

	£000
Linear MCR	28,627
SCR	81,764
MCR cap	36,794
MCR floor	20,441
Combined MCR	28,626
Absolute floor of the MCR	3,331
Minimum Capital Requirement	28,627

E.3. Use of the duration-based equity risk sub-module in the calculation of the Solvency Capital Requirement

Scottish Friendly is not using the duration-based equity risk sub-module.

E.4. Differences between the standard formula and any internal model used

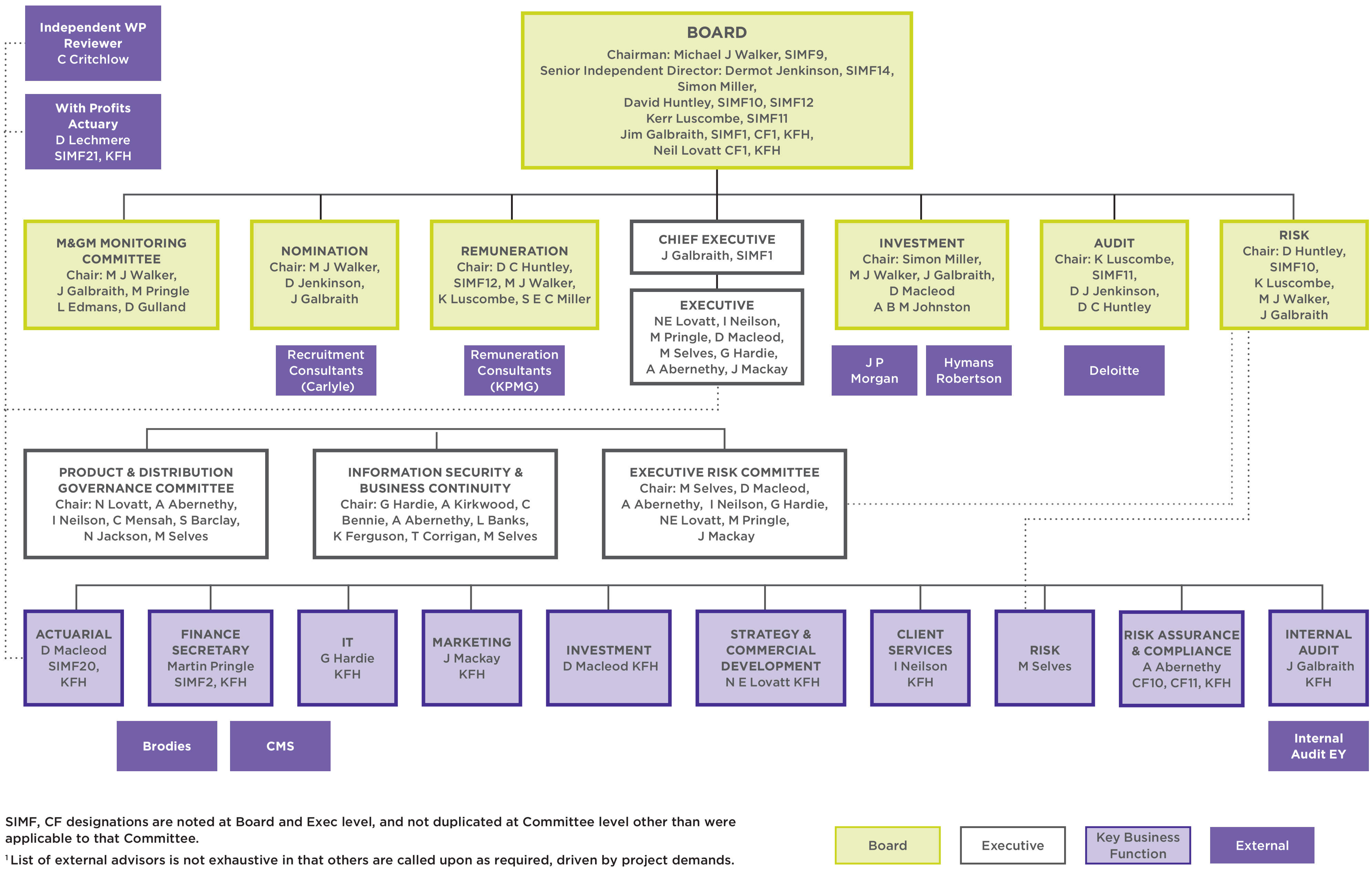
Scottish Friendly has not used an internal model or partial internal model in the calculation of the SCR.

E.5. Non-compliance with the Minimum Capital Requirement and non-compliance with the Solvency Capital Requirement

Scottish Friendly has complied with the Minimum Capital Requirement and the Solvency Capital Requirement throughout the period.

F. Appendices

F.1. Appendix – Functional Structure April 2017



SIMF, CF designations are noted at Board and Exec level, and not duplicated at Committee level other than were applicable to that Committee.

[1] List of external advisors is not exhaustive in that others are called upon as required, driven by project demands.

F.2. Individual Performing Function

SIMF/SIF/KFH	Regulator	Function	Individual Performing Function
SIMF1	PRA	Chief Executive function	Jim Galbraith
SIMF2	PRA	Chief Finance function*	Martin Pringle
SIMF4	PRA	Chief Risk function*	Mike Selves
SIMF20	PRA	Chief Actuary function*	Donald MacLeod
SIMF21	PRA	With Profits Actuary function*	David Lechmere
SIMF9	PRA	Chairman	Michael Walker
SIMF14	PRA	Senior Independent Director	Dermot Jenkinson
SIMF10	PRA	Chair of the Risk Committee	David Huntley
SIMF11	PRA	Chair of the Audit Committee	Kerr Luscombe
SIMF12	PRA	Chair of the Remuneration Committee	David Huntley

*Denotes SIMF's and CFs that are also key functions.

F.3. Public Quantitative Reports Template

The following public Quantitative Reports Templates (QRTs) are disclosed:

S.02.01.02	Balance Sheet
S.05.01.02	Premiums, Claims & Expenses by line of Business
S.05.02.01	Premiums, Claims & Expenses by Country
S.12.01.02	Life & Health SLT Technical Provisions
S.23.01.01	Own Funds
S.25.01.21	Solvency Capital Requirement
S.28.01.01	Minimum Capital Requirement

S.02.01.02
Balance sheet

		Solvency II value
	Assets	C0010
R0030	Intangible assets	
R0040	Deferred tax assets	
R0050	Pension benefit surplus	
R0060	Property, plant & equipment held for own use	3,674
R0070	Investments (other than assets held for index-linked and unit-linked contracts)	761,649
R0080	*Property (other than for own use)*	0
R0090	*Holdings in related undertakings, including participations*	4,528
R0100	*Equities*	448
R0110	*Equities - listed*	0
R0120	*Equities - unlisted*	448
R0130	*Bonds*	83,325
R0140	*Government Bonds*	11,362
R0150	*Corporate Bonds*	69,040
R0160	*Structured notes*	0
R0170	*Collateralised securities*	2,923
R0180	*Collective Investments Undertakings*	653,199
R0190	*Derivatives*	4
R0200	*Deposits other than cash equivalents*	0
R0210	*Other investments*	20,145
R0220	Assets held for index-linked and unit-linked contracts	610,705
R0230	Loans and mortgages	122
R0240	*Loans on policies*	36
R0250	*Loans and mortgages to individuals*	0
R0260	*Other loans and mortgages*	86
R0270	Reinsurance recoverables from:	979,685
R0280	*Non-life and health similar to non-life*	0
R0290	*Non-life excluding health*	
R0300	*Health similar to non-life*	
R0310	*Life and health similar to life, excluding index-linked and unit-linked*	979,685
R0320	*Health similar to life*	0
R0330	*Life excluding health and index-linked and unit-linked*	979,685
R0340	*Life index-linked and unit-linked*	0
R0350	Deposits to cedants	0
R0360	Insurance and intermediaries receivables	10,470
R0370	Reinsurance receivables	
R0380	Receivables (trade, not insurance)	6,937
R0390	Own shares (held directly)	0
R0400	Amounts due in respect of own fund items or initial fund called up but not yet paid in	0
R0410	Cash and cash equivalents	176,509
R0420	Any other assets, not elsewhere shown	2,668
R0500	**Total assets**	2,552,419

		Solvency II value
	Liabilities	C0010
R0510	Technical provisions - non-life	0
R0520	*Technical provisions - non-life (excluding health)*	0
R0530	*TP calculated as a whole*	
R0540	*Best Estimate*	
R0550	*Risk margin*	
R0560	*Technical provisions - health (similar to non-life)*	0
R0570	*TP calculated as a whole*	
R0580	*Best Estimate*	
R0590	*Risk margin*	
R0600	Technical provisions - life (excluding index-linked and unit-linked)	1,676,248
R0610	*Technical provisions - health (similar to life)*	0
R0620	*TP calculated as a whole*	0
R0630	*Best Estimate*	0
R0640	*Risk margin*	0
R0650	*Technical provisions - life (excluding health and index-linked and unit-linked)*	1,676,248
R0660	*TP calculated as a whole*	0
R0670	*Best Estimate*	1,670,702
R0680	*Risk margin*	5,545
R0690	Technical provisions - index-linked and unit-linked	590,969
R0700	*TP calculated as a whole*	0
R0710	*Best Estimate*	587,376
R0720	*Risk margin*	3,593
R0740	Contingent liabilities	
R0750	Provisions other than technical provisions	22,116
R0760	Pension benefit obligations	7,337
R0770	Deposits from reinsurers	51,930
R0780	Deferred tax liabilities	
R0790	Derivatives	
R0800	Debts owed to credit institutions	
R0810	Financial liabilities other than debts owed to credit institutions	
R0820	Insurance & intermediaries payables	6,851
R0830	Reinsurance payables	
R0840	Payables (trade, not insurance)	11,104
R0850	Subordinated liabilities	0
R0860	*Subordinated liabilities not in BOF*	
R0870	*Subordinated liabilities in BOF*	0
R0880	Any other liabilities, not elsewhere shown	3,285
R0900	**Total liabilities**	2,369,839
R1000	**Excess of assets over liabilities**	182,580

S.05.01.02

Premiums, claims and expenses by line of business

Life

		Line of Business for: life insurance obligations						Life reinsurance obligations		Total
		Health insurance	Insurance with profit participation	Index-linked and unit-linked insurance	Other life insurance	Annuities stemming from non-life insurance contracts and relating to health insurance obligations	Annuities stemming from non-life insurance contracts and relating to insurance obligations other than health insurance obligations	Health reinsurance	Life reinsurance	
		C0210	C0220	C0230	C0240	C0250	C0260	C0270	C0280	C0300
	Premiums written									
R1410	*Gross*		40,126	9,842	25,741					75,709
R1420	*Reinsurers' share*		0	0	17,063					17,063
R1500	*Net*		40,126	9,842	8,678					58,646
	Premiums earned									
R1510	*Gross*		40,126	9,842	25,741					75,709
R1520	*Reinsurers' share*		0	0	17,063					17,063
R1600	*Net*		40,126	9,842	8,678					58,646
	Claims incurred									
R1610	*Gross*		92,352	25,045	39,132					156,529
R1620	*Reinsurers' share*		6,436	0	65,070					71,506
R1700	*Net*		85,917	25,045	-25,938					85,024
	Changes in other technical provisions									
R1710	*Gross*		196,972	749	-33,414					164,307
R1720	*Reinsurers' share*		23,571	0	91,434					115,005
R1800	*Net*		173,401	749	-124,848					49,302
R1900	**Expenses incurred**		14,623	2,413	20,368					37,404
R2500	**Other expenses**									
R2600	**Total expenses**									37,404

S.05.02.01

Premiums, claims and expenses by country

Life

		C0150	C0160	C0170	C0180	C0190	C0200	C0210
		Home Country	Top 5 countries (by amount of gross premiums written) - life obligations			Top 5 countries (by amount of gross premiums written) - life obligations		Total Top 5 and home country
R1400			IE					
		C0220	C0230	C0240	C0250	C0260	C0270	C0280
	Premiums written							
R1410	*Gross*	75,205	504					75,709
R1420	*Reinsurers' share*	17,052	11					17,063
R1500	*Net*	58,152	493	0	0	0	0	58,646
	Premiums earned							
R1510	*Gross*	75,205	504					75,709
R1520	*Reinsurers' share*	17,052	11					17,063
R1600	*Net*	58,152	493	0	0	0	0	58,646
	Claims incurred							
R1610	*Gross*	152,367	4,163					156,529
R1620	*Reinsurers' share*	71,506	0					71,506
R1700	*Net*	80,861	4,163	0	0	0	0	85,024
	Changes in other technical provisions							
R1710	*Gross*	164,307						164,307
R1720	*Reinsurers' share*	115,005						115,005
R1800	*Net*	49,302	0	0	0	0	0	49,302
R1900	**Expenses incurred**	37,316	88					37,404
R2500	**Other expenses**							
R2600	**Total expenses**							37,404

S.12.01.02
Life and Health SLT Technical Provisions

			Index-linked and unit-linked insurance			Other life insurance						Health insurance (direct business)					
		Insurance with profit participation		Contracts without options and guarantees	Contracts with options or guarantees		Contracts without options and guarantees	Contracts with options or guarantees	Annuities stemming from non-life insurance contracts and relating to insurance obligation other than health insurance obligations	Accepted reinsurance	Total (Life other than health insurance, including Unit-Linked)		Contracts without options and guarantees	Contracts with options or guarantees	Annuities stemming from non-life insurance contracts and relating to health insurance obligations	Health reinsurance (reinsurance accepted)	Total (Health similar to life insurance)
		C0020	C0030	C0040	C0050	C0060	C0070	C0080	C0090	C0100	C0150	C0160	C0170	C0180	C0190	C0200	C0210
R0010	**Technical provisions calculated as a whole**										0						
R0020	Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default associated to TP calculated as a whole										0						
	Technical provisions calculated as a sum of BE and RM																
	Best estimate																
R0030	**Gross Best Estimate**	1,076,943		587,376			593,759				2,258,078						
R0080	Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default	457,543					522,142				979,685						
R0090	Best estimate minus recoverables from reinsurance/SPV and Finite Re	619,400		587,376	0		71,617	0			1,278,393						
R0100	**Risk margin**	4,420	3,593			1,126					9,138						
	Amount of the transitional on Technical Provisions																
R0110	Technical Provisions calculated as a whole										0						
R0120	Best estimate										0						
R0130	Risk margin										0						
R0200	**Technical provisions - total**	1,081,363	590,969			594,885					2,267,216						

S.23.01.01
Own Funds

	Basic own funds before deduction for participations in other financial sector as foreseen in article 68 of Delegated Regulation 2015/35	**Total**	**Tier 1 unrestricted**	**Tier 1 restricted**	**Tier 2**	**Tier 3**
		C0010	C0020	C0030	C0040	C0050
R0010	Ordinary share capital (gross of own shares)	0	0		0	
R0030	Share premium account related to ordinary share capital	0	0		0	
R0040	Initial funds, members' contributions or the equivalent basic own-fund item for mutual and mutual-type undertakings	0	0		0	
R0050	Subordinated mutual member accounts	0		0	0	0
R0070	Surplus funds	0	0			
R0090	Preference shares	0		0	0	0
R0110	Share premium account related to preference shares	0		0	0	0
R0130	Reconciliation reserve	162,945	162,945			
R0140	Subordinated liabilities	0		0	0	0
R0160	An amount equal to the value of net deferred tax assets	0				0
R0180	Other own fund items approved by the supervisory authority as basic own funds not specified above	0	0	0	0	0
	Own funds from the financial statements that should not be represented by the reconciliation reserve and do not meet the criteria to be classified as Solvency II own funds					
R0220	Own funds from the financial statements that should not be represented by the reconciliation reserve and do not meet the criteria to be classified as Solvency II own funds	0				
	Deductions					
R0230	Deductions for participations in financial and credit institutions	0	0	0	0	
R0290	**Total basic own funds after deductions**	162,945	162,945	0	0	0
	Ancillary own funds					
R0300	Unpaid and uncalled ordinary share capital callable on demand	0				
R0310	Unpaid and uncalled initial funds, members' contributions or the equivalent basic own fund item for mutual and mutual - type undertakings, callable on demand	0				
R0320	Unpaid and uncalled preference shares callable on demand	0				
R0330	A legally binding commitment to subscribe and pay for subordinated liabilities on demand	0				
R0340	Letters of credit and guarantees under Article 96(2) of the Directive 2009/138/EC	0				
R0350	Letters of credit and guarantees other than under Article 96(2) of the Directive 2009/138/EC	0				
R0360	Supplementary members calls under first subparagraph of Article 96(3) of the Directive 2009/138/EC	0				
R0370	Supplementary members calls - other than under first subparagraph of Article 96(3) of the Directive 2009/138/EC	0				
R0390	Other ancillary own funds	0				
R0400	**Total ancillary own funds**	0			0	0
	Available and eligible own funds					
R0500	Total available own funds to meet the SCR	162,945	162,945	0	0	0
R0510	Total available own funds to meet the MCR	162,945	162,945	0	0	
R0540	Total eligible own funds to meet the SCR	162,945	162,945	0	0	0
R0550	Total eligible own funds to meet the MCR	162,945	162,945	0	0	
R0580	**SCR**	81,764				
R0600	**MCR**	28,627				
R0620	**Ratio of Eligible own funds to SCR**	199.29%				
R0640	**Ratio of Eligible own funds to MCR**	569.21%				

	Reconcilliation reserve	C0060
R0700	Excess of assets over liabilities	182,580
R0710	Own shares (held directly and indirectly)	0
R0720	Foreseeable dividends, distributions and charges	
R0730	Other basic own fund items	0
R0740	Adjustment for restricted own fund items in respect of matching adjustment portfolios and ring fenced funds	19,635
R0760	**Reconciliation reserve**	162,945
	Expected profits	
R0770	Expected profits included in future premiums (EPIFP) - Life business	24,093
R0780	Expected profits included in future premiums (EPIFP) - Non- life business	
R0790	**Total Expected profits included in future premiums (EPIFP)**	24,093

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S.25.01.21

Solvency Capital Requirement - for undertakings on Standard Formula

		Gross solvency capital requirement	USP	Simplifications
		C0110	C0080	C0090
R0010	Market risk	65,920		
R0020	Counterparty default risk	11,604		
R0030	Life underwriting risk	10,345		
R0040	Health underwriting risk	0		
R0050	Non-life underwriting risk	0		
R0060	Diversification	-14,585		
R0070	Intangible asset risk	0		
R0100	**Basic Solvency Capital Requirement**	73,284		

	Calculation of Solvency Capital Requirement	C0100
R0130	Operational risk	7,784
R0140	Loss-absorbing capacity of technical provisions	-4,550
R0150	Loss-absorbing capacity of deferred taxes	
R0160	Capital requirement for business operated in accordance with Art. 4 of Directive 2003/41/EC	
R0200	**Solvency Capital Requirement excluding capital add-on**	81,764
R0210	Capital add-ons already set	
R0220	**Solvency capital requirement**	81,764
	Other information on SCR	
R0400	Capital requirement for duration-based equity risk sub-module	
R0410	Total amount of Notional Solvency Capital Requirements for remaining part	12,152
R0420	Total amount of Notional Solvency Capital Requirements for ring fenced funds	70,286
R0430	Total amount of Notional Solvency Capital Requirements for matching adjustment portfolios	
R0440	Diversification effects due to RFF nSCR aggregation for article 304	

S.28.01.01

Minimum Capital Requirement - Only life or only non-life insurance or reinsurance activity

Linear formula component for non-life insurance and reinsurance obligations

		C0010
R0010	MCR_{NL} Result	0

		Net (of reinsurance/SPV) best estimate and TP calculated as a whole	Net (of reinsurance) written premiums in the last 12 months
		C0020	C0030
R0020	Medical expense insurance and proportional reinsurance		
R0030	Income protection insurance and proportional reinsurance		
R0040	Workers' compensation insurance and proportional reinsurance		
R0050	Motor vehicle liability insurance and proportional reinsurance		
R0060	Other motor insurance and proportional reinsurance		
R0070	Marine, aviation and transport insurance and proportional reinsurance		
R0080	Fire and other damage to property insurance and proportional reinsurance		
R0090	General liability insurance and proportional reinsurance		
R0100	Credit and suretyship insurance and proportional reinsurance		
R0110	Legal expenses insurance and proportional reinsurance		
R0120	Assistance and proportional reinsurance		
R0130	Miscellaneous financial loss insurance and proportional reinsurance		
R0140	Non-proportional health reinsurance		
R0150	Non-proportional casualty reinsurance		
R0160	Non-proportional marine, aviation and transport reinsurance		
R0170	Non-proportional property reinsurance		

Linear formula component for life insurance and reinsurance obligations

		C0040
R0200	MCR_{L} Result	28,627

		Net (of reinsurance/SPV) best estimate and TP calculated as a whole	Net (of reinsurance/SPV) total capital at risk
		C0050	C0060
R0210	Obligations with profit participation - guaranteed benefits	614,850	
R0220	Obligations with profit participation - future discretionary benefits	4,550	
R0230	Index-linked and unit-linked insurance obligations	587,376	
R0240	Other life (re)insurance and health (re)insurance obligations	71,503	
R0250	Total capital at risk for all life (re)insurance obligations		714,909

Overall MCR calculation

		C0070
R0300	Linear MCR	28,627
R0310	SCR	81,764
R0320	MCR cap	36,794
R0330	MCR floor	20,441
R0340	Combined MCR	28,627
R0350	Absolute floor of the MCR	3,332
R0400	**Minimum Capital Requirement**	28,627