



SCOTTISH FRIENDLY ASSURANCE SOCIETY LTD

Scottish Friendly's Annual Report to With-Profits Policyholders 2020

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Summary

- 1.1 This report provides details of the review of the treatment of with-profits policyholders and, particularly, the consistency of the treatment with the published Principles and Practices of Financial Management (PPFM), which detail how we manage the with-profits sub-funds.
- 1.2 In the opinion of Scottish Friendly, the management of the with-profits funds over 2020 has materially been in compliance with the obligations of the relevant PPFMs. The With-Profits Committee has considered this report and has decided that an additional report specifically from the With-Profits Committee is not required.
- 1.3 There have been a number of small changes to the PPFMs over 2020. These were mainly intended to clarify the wording and to improve the accessibility of the documents. Other minor changes were made to the principles and the practices to ensure that these accurately reflect the operation and management of the sub-funds.
- 1.4 The COVID-19 outbreak has caused significant disruption to both everyday life and the global economy. During 2020, we regularly monitored the financial strength of the funds, bonus rates and the service provided to customers.
- 1.5 Therefore, bonus rates were reviewed and changed more frequently than under normal circumstances. Under these reviews, which were undertaken under extreme market conditions, the smoothing restrictions on changes in bonus rates that are set out in the PPFMs were partially and temporarily suspended. This was to ensure the fair treatment of both policyholders claiming over 2020 and those continuing to participate going forward. Furthermore, we increased headcount in our Customer Services team to try to maintain the customer experience that our policyholders have come to know and expect.

Purpose

- 2.1 The purpose of this report is to explain how the Scottish Friendly with-profits fund and sub-funds have been managed during 2020 and to demonstrate that we have followed our published 'Principles and Practices of Financial Management' (PPFM) for each sub-fund.
- 2.2 The Conduct of Business sourcebook of the Financial Conduct Authority ('FCA') requires firms to establish and maintain PPFM documents to govern their conduct of their with-profits business.
- 2.3 The FCA also requires the firm to report to its with-profits policyholders stating whether, throughout the financial year to which the report relates, the firm believes it has complied with its obligations relating to each PPFM and setting out the firm's reasons for that belief.

- 2.4 The PPFM documents are available electronically on the Scottish Friendly website: www.scottishfriendly.co.uk¹.
- 2.5 Throughout 2020 Scottish Friendly has published and maintained separate PPFM documents covering the management of the Unitised With-Profits (UWP) Policies and Conventional With-Profits (CWP) Policies written within the Scottish Friendly Main Fund. In addition, separate PPFM documents have been published and maintained throughout 2020 for the Rational Shelley, LANMAS, Scottish Legal, Marine & General and the Manulife sub-funds.
- 2.6 The Principles are high-level statements that reflect the general approach adopted in managing the with-profits fund and are not expected to change often.
- 2.7 The Practices are statements of specific practice employed in managing the with-profits fund. They reflect the current approaches given the particular circumstances of and established ways of managing each fund. Practices are likely to be revised in response to changes in the regulatory, business and economic environment and as new methods and techniques are developed in the life and pensions industry. However, the different Practices would still need to conform to the Principles.
- 2.8 Changes were made to the PPFM documents during 2020 and these are detailed in section 5.

¹<https://www.scottishfriendly.co.uk/members-area/latest-investment-information/principles-and-practices-financial-management>

Compliance with PPFM

- 3.1 In the opinion of Scottish Friendly, the management of the with-profits fund and each sub-fund during 2020 has complied with the obligations detailed in the relevant PPFMs. The reasons for reaching this opinion are detailed in section 4.
- 3.2 Scottish Friendly has a with-profits governance arrangement to ensure that its Board of Directors can satisfy itself at regular intervals that the with-profits business is being managed in accordance with the PPFM. This governance arrangement is the With-Profits Actuary and a With-Profits Committee.
- 3.3 The With-Profits Actuary is Mr. Stephen Makin of Hymans Robertson LLP.
- 3.4 The With-Profits Committee currently consists of four members, who bring a wealth of diverse industry experience. It is chaired by a member who is entirely independent of Scottish Friendly and its Board, with one further independent member and two members who also sit on the Board of Scottish Friendly as Non-Executive Directors. It provides challenge of the With-Profit Actuary's proposals and additional oversight of the fair treatment of with-profits policyholders. The terms of reference for this committee are available on the Scottish Friendly website².
- 3.5 The With-Profits Actuary gives advice and recommendations to the Board and With-Profits Committee on matters relating to with-profits business. This has included an assessment of compliance with the PPFMs.
- 3.6 A report from the With-Profits Actuary to with-profits policyholders is annexed to this report. The With-Profits Committee has considered this report and has decided that an additional report specifically from the With-Profits Committee is not required.

² <https://www.scottishfriendly.co.uk/about-us/board-committee-terms-reference>

How we have complied with our PPFM

Bonus policy and payouts

- 4.1 Owing to the significant market volatility in the first half of 2020, Scottish Friendly resolved to undertake a series of out-of-cycle bonus reviews to ensure that the financial position of the with-profits fund and the sub-funds remained appropriate and that the bonus rates were fair for policyholders exiting and remaining in the funds. This resulted in more frequent changes to the bonus rates than would be the case under normal market conditions.
- 4.2 Under normal market conditions, we aim to “smooth” payouts on policies by only reviewing the level of payouts a small number of times a year and by limiting the change between reviews. In light of the market volatility observed in 2020, we partially and temporarily suspended this smoothing approach to help ensure that payouts were fair for those leaving the fund and those remaining in the fund. This resulted in more frequent monitoring of bonus rates than would normally be expected.
- 4.3 The Bonus Declarations were approved by the Board and reviewed by the With-Profits Committee, based on the recommendations made by the With-Profits Actuary in his Bonus Recommendation Report. Due to the more frequent monitoring required of bonus rates a sub-forum of the Board, including the Chair of the With-Profits Committee, met on a monthly basis and had delegated authority from the Board to approve changes in bonus rates between the normal scheduled assessments.
- 4.4 The assessment of bonus rates met the requirements of the PPFMs in terms of the bonus and smoothing policy detailed therein. These requirements were specifically considered in the more frequent bonus reviews that were undertaken over 2020 due to the market volatility. Furthermore, a backward looking assessment has been undertaken, that has concluded the decisions taken regarding the changes to bonus rates were aligned with the requirements of the PPFMs.
- 4.5 Details of the current bonus rates can be found on our website³.
- 4.6 For most classes of with-profits business, we endeavour to pay a value that reflects the asset share to ensure that fairness is maintained between different groups and generations of policies. As detailed below, the exception are Rational Shelley and Manulife policies. The PPFM contains target ranges for maturity and surrender payouts relative to their asset shares.
- 4.7 The target ranges for each class of business are detailed below:

³ <https://www.scottishfriendly.co.uk/members-area/latest-investment-information/bonus-rates>

Policy Group	Target Range
Scottish Friendly OB (Ordinary Branch)	80% to 120% unsmoothed asset share
Scottish Friendly IB (Industrial Branch)	75% to 200% unsmoothed asset share
Scottish legal Life	70% to 130% unsmoothed asset share
LANMAS	80% to 120% unsmoothed asset share
Marine & General Conventional Business	80% to 120% unsmoothed asset share
Marine & General Unitised Business	90% to 110% unsmoothed asset share
Rational Shelley	Not applicable as asset shares are calculated based on bonus rates
Manulife	Not applicable as asset shares are calculated based on bonus rates and surrender values are formulaic.

- 4.8 The target ranges are set so that the business can be appropriately managed by allowing flexibility in the setting of bonus rates to smooth returns when markets are volatile, and to give confidence to policyholders that payouts will be fair. We set our bonuses with the aim of keeping the majority of our payouts within the applicable target range.
- 4.9 Some target ranges, such as Scottish Legal Life and Scottish Friendly IB, are wider than for the other policy groups listed in the table in Section 4.6. For Scottish Friendly IB and Scottish Legal Life there is a greater number of whole of life policy claims within this sub-fund, which means that it is more difficult to achieve payouts within a small target range.
- 4.10 During 2020 the payouts for maturities and surrenders for the majority of business blocks fell within the target ranges. For blocks where payouts fell outwith the target ranges, further investigations have been carried out, and we are satisfied that, overall, payouts to policyholders over 2020 have been fair.

Investment strategy

- 4.11 Monitoring investment performance and investment strategy is the responsibility of the Board, and the Board delegates responsibility to the Investment Committee. The Investment Committee monitors the investment performance and strategy regularly. For 2020 the investment strategy has been carried out in accordance with the PPFM.
- 4.12 Details of the latest investment information relating to your policy can be found on our website⁴.

⁴ <https://www.scottishfriendly.co.uk/members-area/latest-investment-information>

4.13 The guidelines for the investment strategy can be found in the relevant PPFMs.

Business risk

4.14 Scottish Friendly's with-profits policyholders in the Main Fund ultimately bear the risks and rewards of all business undertaken by Scottish Friendly. Any significant additional business risks to be undertaken by Scottish Friendly require the approval of the Board and Executive, acting on the advice of the With-Profits Actuary. The Board and Executive take into consideration the risks to which with-profits policyholders are and may become exposed, as well as the expectations of achieving appropriate returns for the with-profits policyholders commensurate to the risks borne.

4.15 With-Profits policyholders in other sub-funds are also, although to a lesser extent, exposed to business risks as new business and acquisitions are not written into the sub-funds. The returns in each sub-fund are independent of one another and therefore reflect the risks taken in each sub-fund by the with-profits policyholders.

4.16 Business risks are monitored regularly throughout the year and an annual review of business risks was carried out during 2020.

Charges and expenses

4.17 Scottish Friendly aims to allocate expenses to with-profits policies in a fair manner by giving consideration to the expenses incurred in administering the with-profits business, as well as an appropriate amount of overhead expenses. Consideration is also given to fairness between policies and classes of policies.

4.18 The approach used to setting charges and expenses is regularly reviewed and remains in line with the PPFM.

Management of the estate

4.19 Where a sub-fund has an excess of assets over liabilities this is known as the estate. The management of the estate for each sub-fund is described within the PPFM. The management of the estate has been carried out in line with the PPFM during 2020.

4.20 The use and possible distributions of the estate of each sub-fund has been reviewed over 2020 as part of the annual review. The level of the estate has been monitored regularly over the year to help ensure that the level of any distribution remains appropriate.

Volume of new business

4.21 New business is written in the Scottish Friendly Main Fund only. All sub-funds are closed to new business.

4.22 The volume of new business written over 2020 was substantially in line with the new business plan and meets the requirements set out in the PPFM.

Changes to PPFM documents during 2020

5.1 The following is a summary of the key changes made to the PPFM documents during 2020:

- The wording in the PPFMs was redrafted to increase the clarity of information included.
- The responsibility for advising the Board of the sub-funds counterparty exposure has been clarified to be the Finance Director of Scottish Friendly across all relevant sub-funds. This has no expected impact on policyholder outcomes.
- The use of matching assets and growth assets has been updated in the Scottish Legal Life sub-fund PPFM. The current practice is aligned with the updated principle.
- The description relating to the distribution of the estate and smoothing of pay-outs has been updated for the Scottish Legal sub-fund PPFM. This clarifies that the smoothing of bonus rates will not restrict any distributions of the estate.
- The Scottish Legal PPFM was also amended to clarify the target ranges set out for the policies.
- Information has been removed in the Manulife PPFM relating to target surrender pay-outs, which was not considered to provide a meaningful assessment of fairness. This has been replaced with information to clarify that pay-outs are in line with policy terms and conditions.
- The restrictions of the level of investment in each asset class in all PPFMs have been simplified. This allows Scottish Friendly to respond to market changes and manage the investments within its risk appetite, which protects the financial security of members benefits whilst seeking competitive returns.
- Further updates were made specifically in the Manulife PPFM to amend the target investment strategy to allow a higher investment in fixed interest assets and a lower investment in equities, in line with the expected development of the level of guarantees in the fund.
- Amendments to information around the actions that management may take to manage the financial security of members' guaranteed benefits have been clarified to ensure consistency throughout each of the PPFMs.

- The Manulife PPFM has been amended to clarify that there are no policy loans within the sub-fund.

With-Profit Actuary's report to with-profit policyholders for 2020

Report from the With-Profits Actuary to the with-profits policyholders of Scottish Friendly Assurance Society Limited

The management of with-profits business requires discretion to be exercised, for example by deciding on the bonus rates to apply in determining policy payouts.

As With-Profits Actuary to Scottish Friendly Assurance Society Limited ("Scottish Friendly"), I advise the firm on key aspects of how this discretion is exercised. I am also required to report to the with-profits policyholders every year on whether, in my opinion, Scottish Friendly's annual report to the with-profits policyholders and the discretion exercised by it over the same period take into account in a reasonable and proportionate manner the interests of with-profits policyholders.

I have carried out a review for calendar year 2020 of Scottish Friendly's exercise of discretion and its compliance with the requirements of its Principles and Practices of Financial Management ("PPFM") for the SF Main Fund and for each of the notional sub-funds. The PPFMs are the key documents setting out how Scottish Friendly manages its with-profits business.

Based on my review, it is my opinion that:

- Scottish Friendly's annual report to its with-profits policyholders for 2020, and its exercise of discretion during the year, take into account in a reasonable and proportionate manner the interests of the with-profits policyholders in the SF Main Fund and each of the notional sub-funds,*
- Scottish Friendly has complied materially with the requirements of its PPFM for the SF Main Fund and each of the notional sub-funds, and*
- Scottish Friendly has paid due regard to the information needs of its members.*

My opinion is based on the information and explanations provided to me by Scottish Friendly, on which I have relied, and takes account of Scottish Friendly's annual report to its with-profits policyholders for 2020 (to which this report is appended), Scottish Friendly's PPFMs (which are available on the firm's website), and the relevant rules and guidance issued by the Financial Conduct Authority, the Financial Reporting Council, and the Institute and Faculty of Actuaries.

***Stephen Makin FFA CERA
With-Profits Actuary, Scottish Friendly
June 2021***

For and on behalf of Hymans Robertson LLP