



Scottish Friendly Solvency and Financial Condition Report **December 2017**



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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 2017, The Group has assets under management of over £2.7 billion (2016: £2.7 billion) and has 559,000 members (2016: 513,000).

In 2017 Scottish Friendly achieved record results. Total sales increased by 32% to £44.8m APE (the industry standard measure of annual premium equivalent), statutory earned premiums increased to £93.9m (2016: £75.7m). Under the Solvency II regulations our solvency ratio is 197% (2016: 192%). The solvency ratio is the Own Funds divided by the Solvency Capital Requirement (SCR). Our solvency ratio shows that even in an extreme 1 in 200 year scenario we have enough capital to payout our liabilities to policyholders.

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 a solo report covering Scottish Friendly Assurance Society Ltd 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 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 Company has complied in all material respects with the requirements of the PRA rules and Solvency II Regulations as applicable to the Company; and
- (c) it is reasonable to believe that, at the date of the publication of the SFCR, the Company has continued so to comply, and will continue so to comply in future.

By order of approval of the Board.

J Galbraith

Director

26 April 2018

M Pringle

Director

26 April 2018

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 2017:

- the ‘Valuation for solvency purposes’ and ‘Capital Management’ sections of the SFCR of Scottish Friendly as at 31 December 2017, (‘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 and 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 2017 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) (ISAs (UK)), 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.

Emphasis of Matter – Basis of Accounting

We draw attention to the ‘Valuation for solvency purposes’ and ‘Capital Management’ and/or 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.

Conclusions relating to going concern

We are required by ISAs (UK) 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.

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) 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 External Audit 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

Statutory Auditor

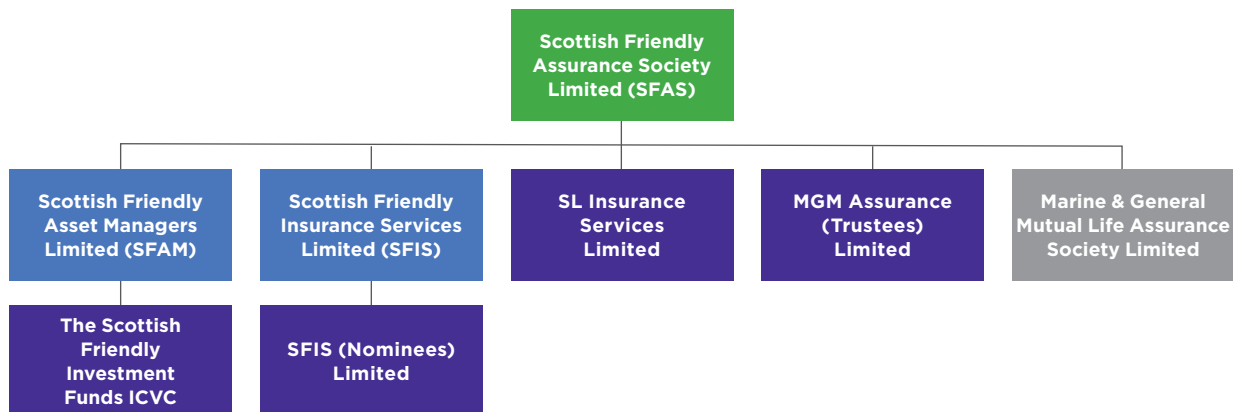
Glasgow, United Kingdom

26 April 2018

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 subject to full SIMR rules.
- Blue** denotes – IFPRU firm, not in scope for SIMR / SMR.
- Purple** denotes – unregulated entity not in scope for SIMR.
- Grey** 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 and the Republic of Ireland. The main products are whole of life policies, endowment assurances, team 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 2017.

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 the Scottish Friendly's performance over 2017, as reflected in the 2017 Annual Report and Accounts:

Technical Account – Long Term Business For year ended 31 December

	Scottish Friendly	
	2017 £000	2016 £000
Earned Premiums	93,940	75,709
Reinsurance Premiums	(33,089)	(17,063)
Earned Premiums, Net of Reinsurance	60,851	58,646
Investment Income	75,269	90,926
Unrealised Gains/(Losses) on Investments	37,427	89,058
Other Technical Income	16,866	9,722
	190,413	248,352
Claims Incurred	171,838	157,004
Reinsurance Claims	(76,439)	(71,505)
Net Claims Incurred	95,399	85,499
Change in Other Technical Provisions	34,973	122,335
Operating Expenses	38,913	35,934
Investment Expenses & Charges	644	995
Tax attributable to Long Term Business	9,581	-
Actuarial (Gain)/Loss re pension scheme	(3,621)	8,426
Transfer to/(from) the Fund for Future Appropriations	14,524	(4,837)
	190,413	248,352

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 2017 and 31 December 2016.

2017

	Insurance with participation £000	Index Linked & Unit Linked Insurance £000	Other Life Insurance £000	Total £000
Gross Premiums	26,771	7,141	60,028	93,940
Gross Claims	73,732	18,513	79,118	171,363
Expense	7,979	1,578	30,473	40,030

A.3. Investment Performance

The return of the asset shares within the Scottish Friendly With-Profits fund for 2017 was 9.2% (2016: 13.7%) reflecting a year where markets continued to rise. This had the impact of boosting final bonus rates for most with-profits customers as at 31 December 2017. Annual bonus rates for certain product classes also increased. Scottish Friendly assets under management grew slightly to £2,706 million (2016: £2,698 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 2017 by asset class, as reflected in the annual report and accounts:

	Scottish Friendly	
	2017 £000	2016 £000
Income from land & buildings	157	139
Income from other investments	26,606	34,162
Net gains on the realisation of investments	48,506	56,625
	75,269	90,926

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 2017 this totalled £16.9 million compared to £9.7 million in 2016.

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 responsibilities 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.

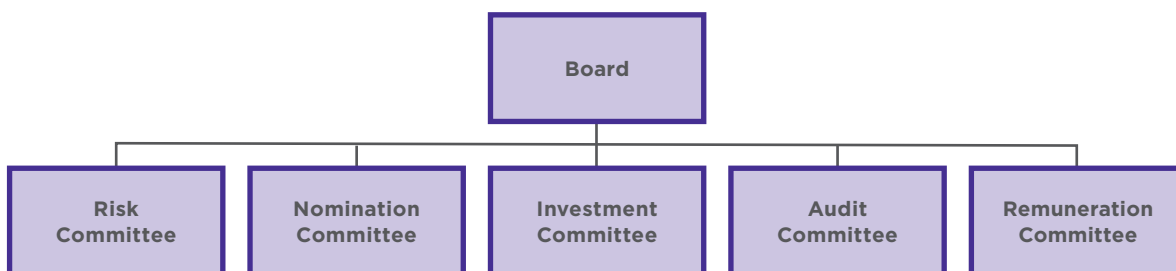
In addition, there are a number of areas where Board Committees have been established, and appropriate powers delegated to them.

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.
- Ensure 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, Non-Executive Directors 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. A range of data is taken into account to inform the review including comparable positions in other organisations, remuneration trends in the financial services sector, as well as wider economic influences. Any change in salary is effective from 1 January. 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 delivering growth and cost efficiencies while generating longer term value for members. Payments are capped at 60% of salary. In line with relevant Solvency II requirements, 40% of bonus payments may be deferred for 3 years, if applicable.

The Executive Directors are entitled to a company car and healthcare insurance.

Non-Executive Director's duties and responsibilities are set out in Scottish Friendly's Governance and Control Procedures Manual. Non-Executive Directors initially hold office until the conclusion of the Annual General Meeting following their appointment, at which they are eligible for election without nomination. The circumstances in which a Board member would be required to vacate office are set out in the Rules of Scottish Friendly.

Fees for the Chairman are set by the Committee in his absence. 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 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 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 seven Directors in respect of Scottish Friendly's products amounted to £30,543 (2016: £23,422).

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

Service contracts

The Executive Directors have service agreements with a notice period of less than 12 months. The service agreements do not have a fixed term and provide for retirement at age 65.

In the event of termination, any payments made would be based on individual circumstances including the reason for termination and contractual obligations.

B.2 Fit and Proper requirements

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, SF 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 an annual 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 including the Own Risk and Solvency Assessment

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.

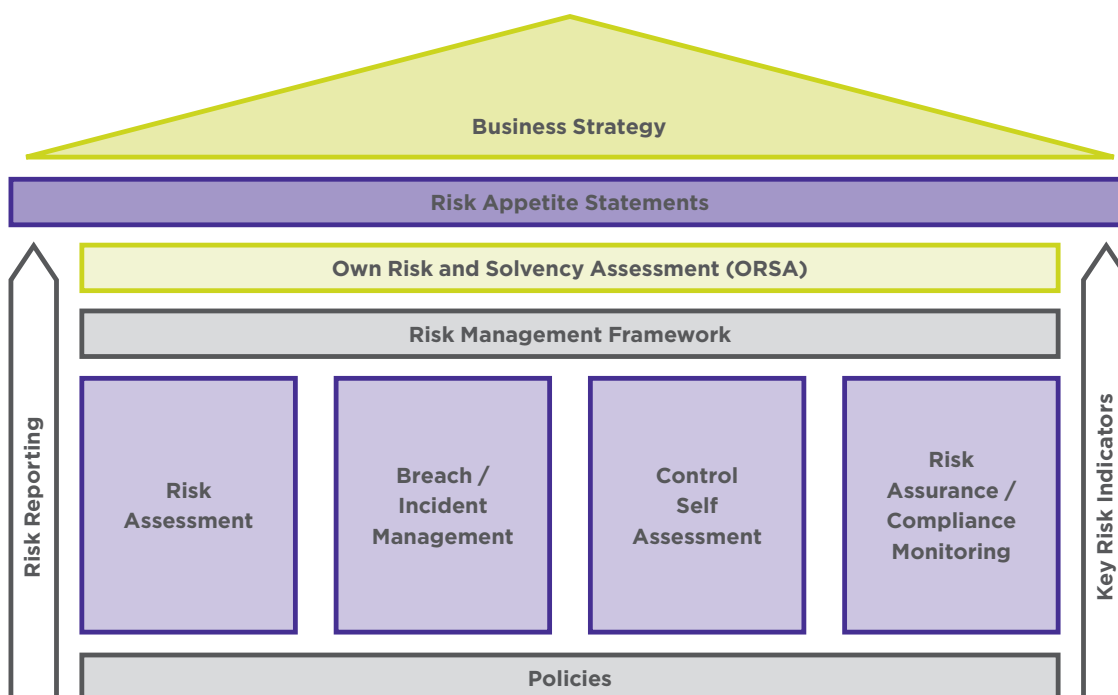
The RMF is integrated with the Solvency and Capital Management activity, in particular the ORSA. The ORSA considers the risks arising from the agreed strategic priorities, how much capital is needed to protect the business against those risks and how resilient the Scottish Friendly business model is 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 and 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 company 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)

SFA 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 ORSA reporting bases;

Undertaking the capital calculations, and ensure 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;

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

Ensure 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;

Supports business strategic initiatives and for example participates in merger and acquisition opportunities.

Assist in the Product Development processes. For example review of: product design, profit testing, specification and appropriate reinsurance arrangements; and

Specifying and implementing claims calculations bases and methods including monitoring and 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 SOLPUR.

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

In addition there are four distribution contracts which involve an element of policy administration (BGL Group, Neilson Financial Services, Ascentric and Nucleus) and two investment management agreements (BlackRock and Legal & General).

B.7. Other Information

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

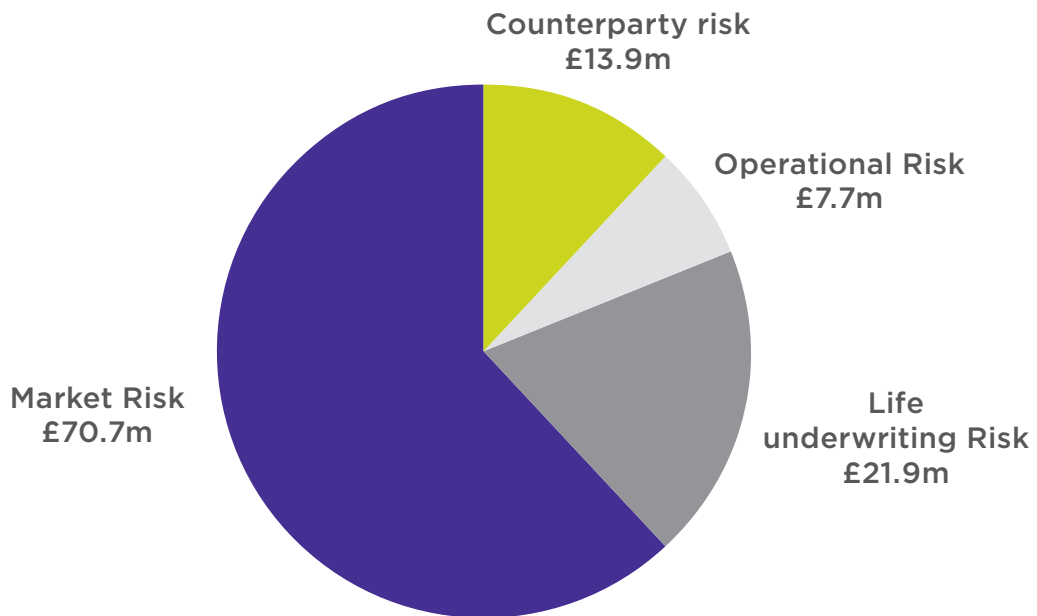
C. Risk Profile

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 Scottish Friendly's Risk Management Framework (RMF). The RMF supports the identification, 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 2017 the total capital required in respect of underwriting risk facing the business was £21.9m. 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
Mortality	1.1	-	-	-	-	1.1
Longevity	0.7	-	0.1	0.5	9.8	11.1
Disability	-	-	-	-	-	-
Lapse	4.0	0.1	-	-	-	4.1
Expense	7.7	-	-	0.1	1.2	9.0
Revision	0.2	-	-	-	0.6	0.8
Catastrophe risk	-	-	-	-	-	-
Diversification	(2.9)	-	-	(0.1)	(1.2)	(4.2)
Total life underwriting risk	10.8	0.1	0.1	0.5	10.4	21.9

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 2017 the total capital required in respect of market risk facing the business was £70.7m. 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
Interest rate risk	1.8	-	-	-	8.5	10.3
Equity risk	11.3	0.4	0.1	0.6	48.7	61.1
Property risk	0.6	-	-	-	1.6	2.2
Spread risk	0.4	-	-	-	1.7	2.1
Currency risk	-	-	-	-	2.0	2.0
Other market risk	-	-	-	-	-	-
Diversification	(1.0)	-	-	-	(5.9)	(6.9)
Total market risk	13.1	0.4	0.1	0.6	56.6	70.8

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

Counterparty default 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 2017 the total capital required in respect of credit risk facing the business was £13.9m. 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
Type 1	8.6	-	-	0.8	4.2	13.6
Type 2	0.4	-	-	-	-	0.4
Diversification	(0.1)	-	-	-	-	(0.1)
Total counterparty risk	8.9	-	-	0.8	4.2	13.9

Note:

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

The primary driver of counterparty default 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 2017 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 2017 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	3.1	0.1	-	0.3	4.5	7.7

The aggregate operational risk amount does not equal the sum of the operational risk for each sub-fund due to the nature of the Standard Formula calculation.

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
- Impact of low interest rates
- Fintech
- Unexpected material expense
- Loss of key partner
- FG16/8 leads to radical back book review
- Cyber crime

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 well capitalised with capital in excess of the SCR and also within internal Risk Appetite measures.

Additional management actions, beyond those 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 2017 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 minimal. As the technical provision and related reinsurance assets are calculated on a Solvency II basis 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) or due to including expected losses on reinsurance recoverables as a result of counterparty default on a Solvency II basis. At the 31 December 2017 no material reclassifications were required.

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

	2017			2016
	Statutory Accounts £000	Solvency II Adjustments £000	Solvency II Balance Sheet £000	Solvency II Balance Sheet £000
Property & Equipment	3,815	-	3,815	3,674
Investments	1,338,079	-	1,338,079	1,372,471
Reinsurance	944,681	(105)	944,576	971,143
Cash	223,485	-	223,485	176,511
Other	11,746	-	11,746	20,075
Total Assets	2,521,806	(105)	2,521,701	2,543,874
Technical Provisions	(2,228,327)	-	(2,228,327)	(2,264,372)
Other	(102,029)	-	(102,029)	(102,623)
Total Liabilities	(2,330,356)	-	(2,330,356)	(2,366,995)
Net Assets	191,450	(105)	191,345	176,879

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 2017.

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 Director believes 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 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 (described as participants in the table) 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 2017 the following investments were held by Scottish Friendly:

	Scottish Friendly			Total £000
	Level 1 £000	Level 2 £000	Level 3 £000	
Financial instrument assets 2017				
Financial investments designated at fair value;				
Shares, other variable yield securities and units in OEICs and unit trusts	1,283,344	515	-	1,283,859
Debt securities and other fixed income securities	6,556	-	4,125	10,681
Participants			3,413	3,413
Private equity investments	-	-	148	148
	1,289,900	515	7,686	1,298,101
Derivative assets	-	-	-	-
Financial assets measured at fair value through profit and loss	1,289,900	515	7,686	1,298,101
Loans and receivables;				
Deposits with credit institutions	-	-	-	39,856
Loans secured by mortgages	-	-	-	86
Policyholder loans	-	-	-	36
				39,978
<i>Total financial assets</i>	-	-	-	1,338,079

	Scottish Friendly			Total £000
	Level 1 £000	Level 2 £000	Level 3 £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
Participants			4,528	4,528
Private equity investments	-	-	448	448
	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
<i>Total financial assets</i>	-	-	-	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 and Statutory Accounts have been calculated on best estimate basis in line with Solvency II requirements. On a Solvency II basis we allow for expected losses on reinsurance recoverables due to counterparty default but this is not allowed for on a Statutory Accounts basis.

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 liability of future policyholders along with a risk margin. 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 key demographic assumptions on a Solvency II basis (expense, mortality, morbidity and persistency) are based on the experience investigations carried out in late 2017 and which were presented to the Board in December 2017. The economic assumptions on a Solvency II basis (e.g. yield curves and volatilities) are based on relevant market data at 31 December 2017.

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 2017 are all valued using a retrospective approach except for the Rational Shelley business, which is valued using a prospective approach - this business block accounts for around 1% 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 once a year using a prospective approach to ensure that they remain appropriate.

	2017 £000	2016 £000
Best Estimate Liabilities	2,210,582	2,255,234
Risk Margin	17,745	9,138
Technical Provisions	2,228,327	2,264,372

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 Accounts and Solvency II.

The total amount of other liabilities is £102m. The key liabilities within this total are detailed in the table below:

	2017 £000	2016 £000
Deposits from reinsurers	48,685	51,930
Outstanding claims	26,602	22,115
Payable (trade)	13,927	11,104
Pension Benefits	997	7,337
Other	11,818	10,137
Total	102,029	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).

There is a small difference between net assets as shown in the financial statements and the Solvency II value excess of assets over liabilities, which is due to allowing for expected losses on reinsurance recoverables due to counterparty default. As at 31 December 2017 excess assets over liabilities were £191.4m on a Statutory Accounts basis and £191.3m on a Solvency II basis.

The following table shows the change in Scottish Friendly's Own Funds from 31 December 2016 to 31 December 2017.

	2017 £000
Opening Own Funds	157,244
Increase/(Decrease) in Total Assets	4,394
(Increase)/Decrease in Technical Provisions	9,478
(Increase)/Decrease in Current Liabilities	594
Total	171,710
Increase/(Decrease) in ring-fencing of available capital	(12,745)
Closing Own Funds	158,965

The assets and liabilities in the table above are shown net of reinsurance.

The Opening Own Funds have been restated due to refinements to the modelling of partnership liabilities that occurred in 2017.

Ring Fenced Funds

The Solvency II excess of assets over liabilities is 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 show below. These sub funds are the Rational Shelley sub fund, LANMAS (London, Aberdeen and Northern Mutual Assurance Society) sub fund, the Scottish Legal Life sub fund and the M&GM sub fund.

	2017 £000	2016 £000
Excess assets over liabilities	191,345	176,879
Adjustment for restrictions due to ring fencing	(32,380)	(19,635)
Own Funds	158,965	157,244

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 stock market 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.

	2017 £000	2016 £000
Own Funds	158,965	157,244
Minimum Capital Requirement	28,288	28,627
Solvency Capital Requirement	80,567	81,764
Solvency Ratio	197.3%	192.3%

Solvency Capital Requirement split by risk modules

The table below shows the risk modules that make up Scottish Friendly Assurance Limited's SCR at 31 December 2017.

	2017 Net SCR £000
Market risk	70,685
Life Underwriting	21,884
Counterparty Default Risk	13,891
Undiversified BSCR	106,460
Diversification Credit	(22,290)
Basic SCR	84,170
Operational Risk	7,660
Adjustment due to RFF/MAP	2,368
Loss-absorbing capacity of technical provisions	(4,082)
Loss-absorbing capacity of deferred taxes	(9,549)
Solvency Capital Requirement	80,567

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.

The Solvency Capital Requirement has not materially changed since the year ended 31 December 2016.

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:

	2017 £000
Linear MCR	28,288
SCR	80,567
MCR cap	36,255
MCR floor	20,142
Combined MCR	28,288
Absolute floor of the MCR	3,251
Minimum Capital Requirement	28,288

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

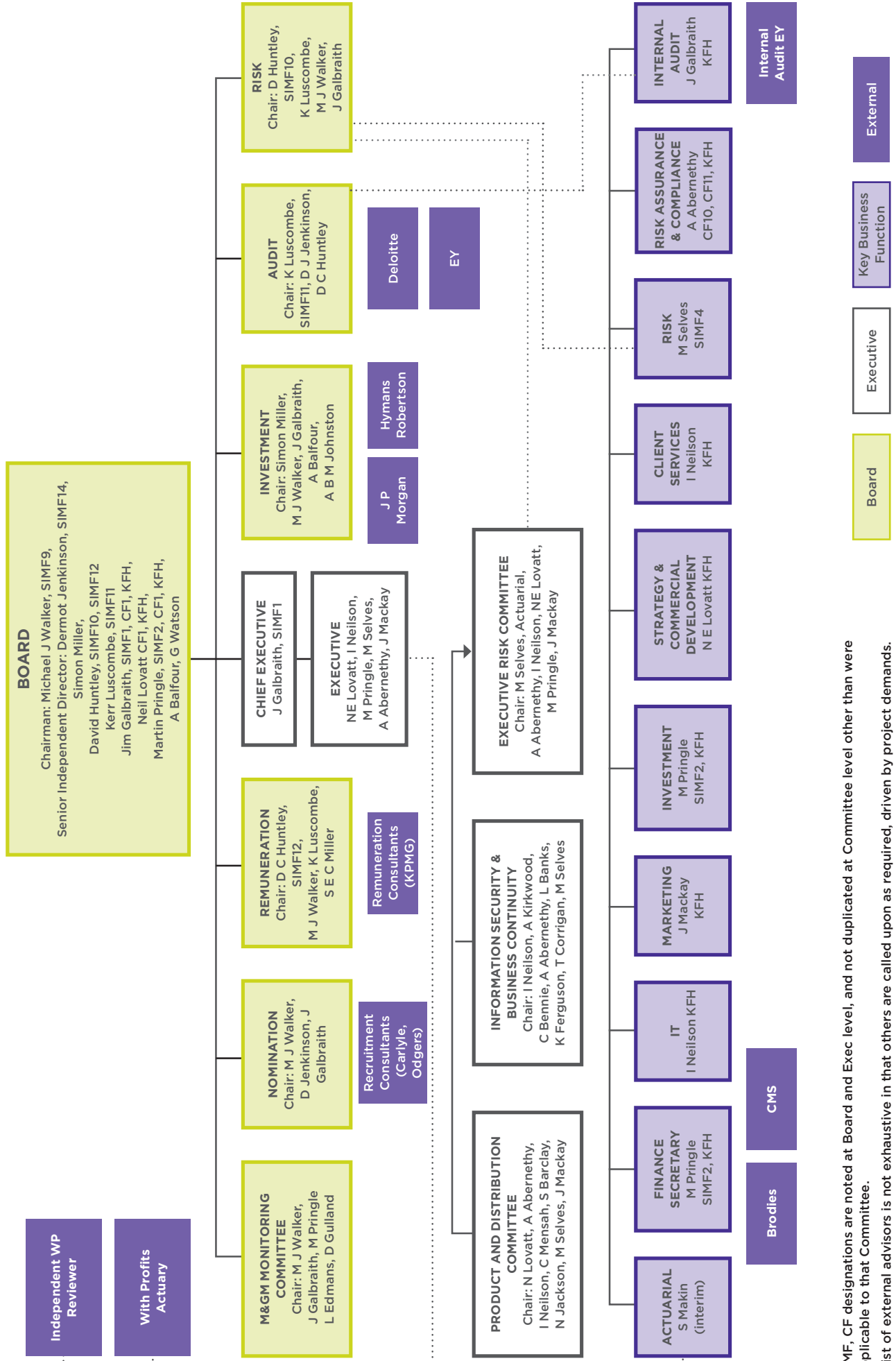
Scottish Friendly has not used an internal model or partial internal model in the calculation of the SCR.

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 2018



SIMF, CF designations are noted at Board and Exec level, and not duplicated at Committee level other than where 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 (resigned 16 April 18)
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.

Details are as at 31 Dec 2017

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
		C0010
Assets		
R0030	Intangible assets	
R0040	Deferred tax assets	
R0050	Pension benefit surplus	
R0060	Property, plant & equipment held for own use	3,814
R0070	Investments (other than assets held for index-linked and unit-linked contracts)	694,956
R0080	<i>Property (other than for own use)</i>	0
R0090	<i>Holdings in related undertakings, including participations</i>	3,413
R0100	<i>Equities</i>	148
R0110	<i>Equities - listed</i>	0
R0120	<i>Equities - unlisted</i>	148
R0130	<i>Bonds</i>	10,269
R0140	<i>Government Bonds</i>	6,145
R0150	<i>Corporate Bonds</i>	0
R0160	<i>Structured notes</i>	0
R0170	<i>Collateralised securities</i>	4,125
R0180	<i>Collective Investments Undertakings</i>	660,273
R0190	<i>Derivatives</i>	0
R0200	<i>Deposits other than cash equivalents</i>	20,854
R0210	<i>Other investments</i>	0
R0220	Assets held for index-linked and unit-linked contracts	643,000
R0230	Loans and mortgages	123
R0240	<i>Loans on policies</i>	37
R0250	<i>Loans and mortgages to individuals</i>	86
R0260	<i>Other loans and mortgages</i>	0
R0270	Reinsurance recoverables from:	944,576
R0280	<i>Non-life and health similar to non-life</i>	0
R0290	<i>Non-life excluding health</i>	0
R0300	<i>Health similar to non-life</i>	0
R0310	<i>Life and health similar to life, excluding index-linked and unit-linked</i>	944,576
R0320	<i>Health similar to life</i>	0
R0330	<i>Life excluding health and index-linked and unit-linked</i>	944,576
R0340	<i>Life index-linked and unit-linked</i>	0
R0350	Deposits to cedants	0
R0360	Insurance and intermediaries receivables	7,026
R0370	Reinsurance receivables	0
R0380	Receivables (trade, not insurance)	2,696
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	223,485
R0420	Any other assets, not elsewhere shown	2,025
R0500	Total assets	2,521,700

S.02.01.02

Balance sheet

		Solvency II value
		C0010
Liabilities		
R0510	Technical provisions - non-life	0
R0520	<i>Technical provisions - non-life (excluding health)</i>	0
R0530	<i>TP calculated as a whole</i>	
R0540	<i>Best Estimate</i>	
R0550	<i>Risk margin</i>	
R0560	<i>Technical provisions - health (similar to non-life)</i>	0
R0570	<i>TP calculated as a whole</i>	
R0580	<i>Best Estimate</i>	
R0590	<i>Risk margin</i>	
R0600	Technical provisions - life (excluding index-linked and unit-linked)	1,642,629
R0610	<i>Technical provisions - health (similar to life)</i>	0
R0620	<i>TP calculated as a whole</i>	0
R0630	<i>Best Estimate</i>	0
R0640	<i>Risk margin</i>	0
R0650	<i>Technical provisions - life (excluding health and index-linked and unit-linked)</i>	1,642,629
R0660	<i>TP calculated as a whole</i>	0
R0670	<i>Best Estimate</i>	1,628,691
R0680	<i>Risk margin</i>	13,938
R0690	Technical provisions - index-linked and unit-linked	585,698
R0700	<i>TP calculated as a whole</i>	614,065
R0710	<i>Best Estimate</i>	-32,174
R0720	<i>Risk margin</i>	3,807
R0740	Contingent liabilities	
R0750	Provisions other than technical provisions	
R0760	Pension benefit obligations	997
R0770	Deposits from reinsurers	48,685
R0780	Deferred tax liabilities	9,549
R0790	Derivatives	
R0800	Debts owed to credit institutions	
R0810	Financial liabilities other than debts owed to credit institutions	
R0820	Insurance & intermediaries payables	32,683
R0830	Reinsurance payables	
R0840	Payables (trade, not insurance)	4,378
R0850	Subordinated liabilities	0
R0860	<i>Subordinated liabilities not in BOF</i>	
R0870	<i>Subordinated liabilities in BOF</i>	0
R0880	Any other liabilities, not elsewhere shown	5,736
R0900	Total liabilities	2,330,355
R1000	Excess of assets over liabilities	191,345

S.12.01.02

Life and Health SLT Technical Provisions

	Index-linked and unit-linked insurance				Other life insurance			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)	Health insurance (direct business)			Annuities stemming from non-life insurance contracts and relating to health insurance obligations	Health reinsurance (reinsurance accepted)	Total (Health similar to life insurance)
	Insurance with profit participation		Contracts without options and guarantees	Contracts with options or guarantees		Contracts without options and guarantees	Contracts with options or guarantees					Contracts without options and guarantees	Contracts with options or guarantees			
	C0020	C0030	C0040	C0050	C0060	C0070	C0080	C0090	C0100	C0150	C0160	C0170	C0180	C0190	C0200	C0210
R0010 Technical provisions calculated as a whole		614,065								614,065						
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						
R0020																

Technical provisions calculated as a sum of BE and RM

Best estimate

R0030 Gross Best Estimate	1,061,548		-32,174					567,143			1,596,517					
Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default	455,048							489,529			944,576					
R0090 Best estimate minus recoverables from reinsurance/SPV and Finite Re	606,500		-32,174	0				77,615	0		651,940					
R0100 Risk margin	11,570	3,807									17,745					
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	1,073,118	585,698						569,511			2,228,327					

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

R0010	Ordinary share capital (gross of own shares)
R0030	Share premium account related to ordinary share capital
R0040	Initial funds, members' contributions or the equivalent basic own-fund item for mutual and mutual-type undertakings
R0050	Subordinated mutual member accounts
R0070	Surplus funds
R0090	Preference shares
R0110	Share premium account related to preference shares
R0130	Reconciliation reserve
R0140	Subordinated liabilities
R0160	An amount equal to the value of net deferred tax assets
R0180	Other own fund items approved by the supervisory authority as basic own funds not specified above
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
R0230	Deductions for participations in financial and credit institutions
R0290	Total basic own funds after deductions

Ancillary own funds

R0300	Unpaid and uncalled ordinary share capital callable on demand
R0310	Unpaid and uncalled initial funds, members' contributions or the equivalent basic own fund item for mutual and mutual - type undertakings, callable on demand
R0320	Unpaid and uncalled preference shares callable on demand
R0330	A legally binding commitment to subscribe and pay for subordinated liabilities on demand
R0340	Letters of credit and guarantees under Article 96(2) of the Directive 2009/138/EC
R0350	Letters of credit and guarantees other than under Article 96(2) of the Directive 2009/138/EC
R0360	Supplementary members calls under first subparagraph of Article 96(3) of the Directive 2009/138/EC
R0370	Supplementary members calls - other than under first subparagraph of Article 96(3) of the Directive 2009/138/EC
R0390	Other ancillary own funds
R0400	Total ancillary own funds

Available and eligible own funds

R0500	Total available own funds to meet the SCR
R0510	Total available own funds to meet the MCR
R0540	Total eligible own funds to meet the SCR
R0550	Total eligible own funds to meet the MCR

R0580 SCR

R0600 MCR

R0620 Ratio of Eligible own funds to SCR

R0640 Ratio of Eligible own funds to MCR

Reconciliation reserve

R0700	Excess of assets over liabilities
R0710	Own shares (held directly and indirectly)
R0720	Foreseeable dividends, distributions and charges
R0730	Other basic own fund items
R0740	Adjustment for restricted own fund items in respect of matching adjustment portfolios and ring fenced funds
R0760	Reconciliation reserve

Expected profits

R0770	Expected profits included in future premiums (EPIFP) - Life business
R0780	Expected profits included in future premiums (EPIFP) - Non- life business
R0790	Total Expected profits included in future premiums (EPIFP)

Total	Tier 1 unrestricted	Tier 1 restricted	Tier 2	Tier 3
C0010	C0020	C0030	C0040	C0050
0	0		0	
0	0		0	
0	0		0	
0		0	0	0
0	0			
0		0	0	0
0		0	0	0
158,965	158,965			
0		0	0	0
0				0
0	0	0	0	0
0				
0	0	0	0	0
0				
158,965	158,965	0	0	0

0				
0				
0				
0				
0				
0				
0				
0				
0				
0				
0				
0			0	0

158,965	158,965	0	0	0
158,965	158,965	0	0	
158,965	158,965	0	0	0
158,965	158,965	0	0	

80,567
28,288
197.31%
561.95%

C0060
191,345
0
0
32,380
158,965

11,762
11,762

S.25.01.21

Solvency Capital Requirement - for undertakings on Standard Formula

Gross solvency capital requirement	USP	Simplifications
C0110	C0090	C0120
72,673		
14,282		
22,499		
0		
0		
-22,917		
0		
86,538		
Calculation of Solvency Capital Requirement		
C0100		
7,660		
-4,082		
-9,549		
0		
80,567		
0		
80,567		
Other information on SCR		
0		
18,722		
62,895		
0		
0		

- R0010 Market risk
- R0020 Counterparty default risk
- R0030 Life underwriting risk
- R0040 Health underwriting risk
- R0050 Non-life underwriting risk
- R0060 Diversification

R0070 Intangible asset risk

R0100 **Basic Solvency Capital Requirement**

Calculation of Solvency Capital Requirement

- R0130 Operational risk
- R0140 Loss-absorbing capacity of technical provisions
- 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**
- R0210 Capital add-ons already set
- R0220 **Solvency capital requirement**

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
- R0420 Total amount of Notional Solvency Capital Requirements for ring fenced funds
- R0430 Total amount of Notional Solvency Capital Requirements for matching adjustment portfolios
- R0440 Diversification effects due to RFF nSCR aggregation for article 304

