Foresters Friendly Society

Solvency and Financial Condition Report as at 31 December 2019

V5.0 1 June 2020

Contents

Summary

Considerations for 2019

This Solvency and Financial Condition Report ('SFCR') has been prepared to enable members of Foresters Friendly Society ('the Society') and other stakeholders to assess the financial position of the Society at 31 December 2019.

This SFCR includes:

- a description of the Society's business;
- analysis of the business performance;
- information regarding the system of governance;
- details of the Society's risk profile;
- a valuation of the Society's assets and liabilities; and
- a summary of the solvency position of the Society as at 31 December 2019.

The Society has opted to not have the SFCR and accompanying QRT disclosures externally audited, in line with Policy Statement 25/18 published by the PRA on 17 October 2018. However, many of the underlying methods, assumptions, processes and controls used for the Solvency II valuation are also used for the UK GAAP valuation of technical provisions within the annual report and accounts, which is subject to external audit.

There have been a number of developments over 2019, these include:

- Individual new business sales grew significantly in 2019. New single premiums including top-ups on existing plans were £6.4m (2018: £4.5m). The annualised premium on new regular premium policies was £1.5m (2018: £1.3m).
- Group business premiums grew to £14.4m (2018: £13.2m).
- Investment performance was good across all asset classes with the FTSE All Share index performing exceptionally well, providing a total return of 19.2% (2018: -9.5%).
- Investment management has been transferred to AXA Investment Managers from Quilter Cheviot in July 2019, implementing a new investment strategy for the various asset portfolios across the Society.
- Following the resignation of Chief Executive Officer, Paul Osborn, Erik Vynckier, former Non-Executive Director, held the position on an interim basis for 6 months from July 2019. Rachel Hardy was appointed to succeed Erik Vynckier from January 2020, whilst maintaining her position as Chief Financial Officer.
- In parallel to the above, the Society reduced the number Executive Directors from three to one.
- The Actuarial Function has been outsourced to Zenith Actuarial Limited, effective from 1 January 2020, and the role of Chief Actuary has been brought back in-house, effective from March 2020.

More details of our strategic initiatives can be found in our annual report and accounts document, published on our website (www.forestersfriendlysociety.co.uk/about-us/reports-governance).

The 2019 year-end valuation shows that the Society is solvent with Own Funds of £42.0m (2018: £44.6m), with a capital coverage ratio ('CCR', Own Funds coverage of SCR) of 111% (2018: 115%), which is below the target CCR of 115%.

The CCR for the UK Insurance Funds (excluding UK Courts and Guernsey ring-fenced funds) is 128% (2018: 134%), which is below the target CCR of 140%.

The Society is focused on capital optimisation options to increase the CCR of the Society.

The CCR for the Order Insurance Fund ('OIF') is 221% (2018: 128%) and above the target CCR of 150%. The increase in CCR is a result of capital optimisation activities within the fund and holding fewer equities than the benchmark allocation.

Section E provides further information on the change in the own funds as a percentage of the SCR.

COVID-19

The Directors have been monitoring the development of the impact of COVID-19, both directly on the Society's business and indirectly through reviewing the development of government policy and advice. The main considerations are as follows.

Members

In the increasingly likely event of an economic recession, there will be members of the Society who will suffer. The Society offers benevolent grants to its members and is encouraging, through its Court Network, active promotion of these member benefits. Our Foresters Support Fund offers discretionary grants to assist our adult members (over 18 years of age and who have been a member for at least 6 months) in times of hardship or distress by paying up to £2,000. For example, we have been able to help members affected by the recent floods and members facing illness or financial difficulties. We feel it is only right that this Fund now supports those who have been affected by COVID-19.

Operational

The Directors have made the decision to implement aspects of the Society's business continuity plan (BCP), specifically advising staff at all levels and in all functions to work at home, wherever practicable, and to minimise the need for gatherings of staff. Communications within the Society are now almost wholly via telephone, email or messaging applications. The Society's IT facilities are adequate to maintain operations on this basis for the foreseeable future albeit some processes may take longer to run than usual. The Directors expect that further operational changes will continue to be required.

The Directors are mindful of the differing pressures on individual members of staff, and that these pressures change as the position nationally and locally develops. The Society has an employee assistance programme in place to support the mental well-being of staff during this challenging time.

Risks underwritten

The Society has written policies that provide benefits in ill-health and in the event of death.

The Society's Group business is the largest concentration of risk with respect to the current situation, primarily resulting from a potential increase in death claims.

The Society is also exposed to claims from ill-health. The largest concentration of this risk is also in the Society's Group business. However, the sick pay benefits offered in this business line provide for a 26-week deferred period, so the additional risk from COVID-19 illness is expected to be small.

The Society has mortality catastrophe reinsurance in place, which explicitly covers pandemics, including the one we are currently experiencing. This offers the Society protection against COVID-19 related claims in excess of £0.5 million in the six-month period commencing on 11 March 2020.

Investment portfolio

Since the year end, investment markets have significantly deteriorated due to the uncertainty COVID-19 brings to the future state of the global economy. As at the date of signing these financial statements, the Society has sold the entirety of its equity and convertible bond portfolios held in the with-profits Order Insurance Fund, the Tunstall Fund and the Non-Profit Fund. The POIS with-profits fund is financially strong and is expected to be able to maintain its limited equity holdings through the current crisis.

The Society's remaining major holdings in equity remains in the POIS unit-linked business funds where the investment risk is borne by policyholders. These have significant equity exposure by design. From 31 December 2019 to the 31 March 2020, the unit prices of these funds have dropped as follows:

Fund	Unit price on 31 Dec 2019 (p)	Unit price on 31 March 2020 (p)	Change
POIS Savings Fund	226.80	183.00	-19%
POIS Flexible Growth Fund	116.20	95.11	-18%
POIS Money Bond Fund	198.90	189.30	-5%

The Directors do not view this as a permanent drop but continue to keep the position under close review.

The market value of the Society's fixed interest portfolios has also fallen since the year end, although far less significantly than equities, with corporate bonds being the most affected having fallen in value by around 10% as credit spreads have widened. The Directors are mindful that the credit risk in that portfolio is likely to have increased. The Society is also affected by the reduction in yields on risk-free assets such as UK government bonds. This reduction increases its technical provisions in respect of the cost of guarantees. Property valuations have not yet been reperformed and the property portfolio is being monitored for signs of any significant deterioration in rent collections. The Society's property portfolio is estimated to have fallen by approximately 2% in capital value over the first quarter of 2020 based on comparison to publicly available property indices and property fund prices.

Solvency Position and Forecasts

The Directors are closely monitoring the Society's capital coverage ratio in these volatile market conditions to assess the Society's compliance with regulatory capital requirements in the context of the risk appetite determined by the Board. The Society's 2019 Own Risk and Solvency Assessment report ('ORSA') included a pandemic scenario which considered a loss event for the Society as a result of increased incidence of sickness, mortality and associated operational risk losses. The scenario showed that the Society continued to operate within its capital coverage ratio risk appetite despite the impact of such an event.

The Directors recognise that as the foreseeable scenarios change, decisions may need to be made in relation to the scale of the Society's activity and the level of capital maintained to support that activity. The Board is considering the need for an ad hoc ORSA, but is mindful of where Management time is best spent to ensure the Society's resilience in the current economic climate.

Going Concern

As at the date of signing these financial statements, the Directors' forecasts up to 31 December 2024 indicate that the Society will be able to maintain liquidity and a surplus over its Solvency Capital Requirement. It will therefore be able to continue to trade as a going concern. However, there are foreseeable scenarios in which this position may be under threat; the Society was already outside of its risk appetite at 31 December 2019.

The Society is considering a number of further actions to improve its capital coverage ratio including:

- launching a new with-profits product to improve the Society's competitive position;
- increasing reinsurance cover; and
- consolidating sub funds.

However, these are longer-term actions, and launching a new product may reduce the Society's CCR in the short term.

The Directors are continuously monitoring the Society's financial position and outlook. Further actions, in addition to those actions already taken, will be taken if the Society's capital coverage ratio continues to deteriorate.

Board Declaration

The Board is responsible for all information contained within this Solvency and Financial Condition Report and is satisfied that:

(a) throughout 2019, the Society has complied in all material respects with the requirements of the PRA rules and Solvency II Regulations applicable to the Society; and

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

This 2019 Solvency and Financial Condition Report was approved by the Board on 1 June 2020 and authorised for issue.

On behalf of the Board:

John Instance	**Rachel Hardy**	**Lisa Russell**
Chairman	**Chief Executive**	**Company Secretary**

A. Business and Performance

A.1 Business

Foresters Friendly Society ('the Society') is the trading name of The Ancient Order of Foresters Friendly Society Limited, which is an Incorporated Friendly Society (Registration No. 511F). The Society's registered office is 29 - 33 Shirley Road, Southampton, SO15 3EW. The Society is wholly owned by its members, who are all assigned to a local branch ('Court').

Financial Regulator

The Society is authorised by the Prudential Regulation Authority ('PRA') and regulated by the Prudential Regulation Authority and the Financial Conduct Authority (FCA) under Registration No. 110029.

PRA
Telephone: 020 3461 7000
Address: Firms Enquiries Team (MG1-SE)
Prudential Regulation Authority
20 Moorgate
London, EC2R 6DA

FCA
Telephone: 0300 500 0597
Address: FCA Head office
25 The North Colonnade
London, E14 5HS

Lines of business

The Society consists of its Insurance and Court operations including the Guernsey Court's general insurance business. The consolidated ('Group') results include the results of the Leeds Investment Association (a Specially Authorised Friendly Society registered under the Friendly Societies Act). Foresters General Insurance Services Limited is a wholly owned subsidiary and is consolidated within these financial statements.

The Insurance business is divided into two distinct parts:

- products available to individuals, either directly from the Society or via a network of Introducers and Financial Adviser intermediaries in the UK and Guernsey; and
- products provided to organisations as Group Schemes, which cover a range of organisations including police federations and agencies of charity workers.

The Society offers a range of financial products that are simple and affordable and are backed by excellent customer service. The main products are:

Product	Description
Tax-Exempt Savings Plan (TESP)	A long-term tax-exempt regular savings plan with a guaranteed tax-free cash sum at the end of the chosen term and the potential for bonuses to increase the policy value.
With-Profits (Stocks & Shares) ISA	A flexible medium to long-term tax-free savings plan that can accept regular investments or one-off lump sum investments up to the maximum annual ISA limit. There is the potential for bonuses to increase the policy value.

Product	Description
Lifetime ISA ('LISA')	A savings account that enables saving towards purchasing a first-time buyer property with a value of less than £450,000; and/or to provide a method of saving for retirement. Contributions of up to £4,000 in each tax year are permitted and the government will add a bonus of 25% to member monies paid into the LISA.
Junior ISA ('JISA')	A tax-free with-profits savings plan for the under 18s that can accept regular investments or one-off lump sum investments up to the maximum annual Junior ISA limit. There is the potential for bonuses to increase the policy value.
Bond	A single lump sum investment with the potential for bonuses to be added over the medium to long-term.
50+ Life Cover	A with-profits whole of life insurance policy for the over 50s, providing a guaranteed tax-free cash sum on death which has the potential to grow with bonuses over time. The monthly premiums are fixed at outset and guaranteed not to change.
Unit-Linked Savings and Investment Plan	A long-term regular savings plan of which the premium is used to allocate units in the POIS Savings Fund. The fund invests mainly in UK stocks and shares for a potential for growth over the longer term.
Unit-Linked Tax-Exempt Savings Plan	A long-term tax-exempt regular savings plan of which the premium is used to allocate units in the POIS Flexible Growth Fund. The fund invests in a range of investments such as gilts, corporate bonds and equities, both UK and overseas, for the potential of long-term growth.
Medical Expense Insurance	Individual medical expense insurance covering primary healthcare costs of residents of Guernsey and Alderney. This business is regulated by the Guernsey Financial Services Commission.
Group Life & Sickness Schemes	These are set up by trustees, employers or employee groups to provide life assurance, critical illness and/or income protection benefits for participants. The participants have the option of joining the scheme and paying the appropriate premiums for the selected benefits. A range of different benefit types is available, and these are tailored to the individual scheme.

The current channels to market for individual sales are:

- online advertising and social media (Facebook, Twitter, LinkedIn and others);
- direct mail and an internal telemarketing team;
- introducers (Courts and POIS);
- Independent Financial Advisers ('IFA') or Professional Introducers; and
- newspaper and radio advertising for the Guernsey business.

The distribution of Group Schemes is carried out through specialist brokers.

Significant events in the reporting period

The Society's CCR has dropped to 111% (2018: 115%) and this is within the Amber category of the Society's capital risk appetite framework. The current level of CCR, and the impact of Covid-19 following year-end, means that the Board is urgently investigating options to improves the Society's overall CCR.

A.2 Underwriting Performance

The following table shows the underwriting performance by line of business over the reporting period for the Society's UK insurance business.

Technical Account: Long Term Business (£'000)	With-Profits	Unit-Linked	Non-Profit	Group	2019 Total	Restated 2018 Total
Earned premiums, net of reinsurance						
Gross premium written	10,230	5,712	274	14,459	30,675	27,926
Outward reinsurance premiums	(67)	-	-	(168)	(235)	(258)
Net premium written	**10,163**	**5,712**	**274**	**14,291**	**30,440**	**27,668**
Investment income	7,696	6,930	(680)	-	13,946	6,828
Net unrealised gains on investments	2,676	-	2,045	-	4,721	(12,662)
Total technical income	**20,535**	**12,642**	**1,639**	**14,291**	**49,107**	**21,834**
Claims incurred						
Gross claims payable	(10,350)	(7,178)	(216)	(13,089)	(30,833)	(30,038)
Change in other technical provisions						
Long term business provision:						
- gross amount	(9,159)	-	541	946	(7,672)	7,977
- reinsurers' share	23	-	-	(145)	(122)	15
- net of reinsurance	(9,136)	-	541	801	(7,794)	7,992
Technical provisions for linked business:						
- net of reinsurance	-	(3,874)	(769)	-	(4,643)	6,802
Net change	**(9,136)**	**(3,874)**	**(228)**	**801**	**(12,437)**	**14,794**
Other expenditure						
- net operating expenses	(2,714)	(1,259)	(1,975)	(763)	(6,712)	(5,950)
- amortisation of PVIF	-	-	-	-	-	(700)
- investment expenses and charges	(222)	(126)	(439)	-	(787)	(777)
Total other expenditure	**(2,936)**	**(1,385)**	**(2,415)**	**(763)**	**(7,499)**	**(7,427)**
Total technical charges	**(22,422)**	**(12,437)**	**(2,858)**	**(13,051)**	**(50,769)**	**(22,671)**
Surplus of technical income over technical charges (before expense subsidies)	**(1,887)**	**205**	**(1,219)**	**1,240**	**(1,662)**	**(837)**
With-Profits expense subsidies	1,132	-	(1,132)	-	-	-
Surplus of technical income over technical charges	**(755)**	**205**	**(2,352)**	**1,240**	**(1,662)**	**(837)**
Transfer from/(to) Fund for Future Appropriations	755	(205)	2,352	(1,240)	1,662	837
Balance on technical account	**-**	**-**	**-**	**-**	**-**	**-**

There was a net transfer from the Fund for Future Appropriations ('FFA') of £1.7m over the reporting period (2018: £0.8m transfer from FFA). Profits from the Group business has been offset by an overall loss from individual business and the Society's IT project costs over 2019 of £2.1m.

The NPF provided £1.1m (2018: £0.9m) of support to the with-profits funds through expense cap arrangements.

2018 results have been restated to reflect a change in timing of premium recognition.

The following table shows the underwriting performance over the reporting period for the Society's Guernsey insurance business.

Technical Account: General Business (£'000)	2019	2018
Earned premiums, net of reinsurance		
Gross premium written	2,475	2,443
Investment income	-	129
Total Technical Income	**2,475**	**2,572**
Claims incurred		
Gross claims payable	(2,179)	(2,260)
Other Expenditure		
Net operating expenses	(154)	(151)
Total Technical Charges	**(2,333)**	**(2,411)**
Surplus of technical income over technical charges	**142**	**161**
Transfer from/(to) general business fund	(142)	(161)
Balance on Technical Account	**-**	**-**

There was a net transfer to the General Business Fund of £0.14m over the reporting period (2018: £0.16m).

A.3 Investment Performance

Investment income and expenses

The table below shows the Society's investment income and expenses earned on the assets supporting the Society's UK long-term insurance business and the medical expense insurance business written by the Guernsey Court.

'Other investments' comprises cash, units in authorised unit trusts, loans, mortgages, deposits with credit institutions and deposits with Investment Associations. The Society does not invest directly in derivative investments.

Technical Account (£'000)	2019	2018
UK long-term insurance business		
Investment income		
Income from property investments	-	349
Income from listed investments	2,608	5,214
Income from other investments	339	284
Gains/(Losses) on realisation of property investments	-	59
Gains/(Losses) on realisation of listed investments	10,999	922
Total investment income	**13,946**	**6,828**
Total unrealised gains/(losses) on investments	**4,721**	**(12,662)**
Total UK investment returns	**18,667**	**(5,834)**
Investment management expenses and charges	**787**	**777**
Guernsey medical expense insurance business		
Income from investments	-	129
Gains/(Losses) on investments	-	-
Unrealised gains/(losses) on investments	-	-
Total Guernsey investment returns	**-**	**129**

Investment returns over 2019 were very good, with gains across all asset classes. The Society's UK long-term insurance business did not directly hold property over 2019, rather property exposure was gained through a collective fund.

The large amount of realised gains in 2019 relates to the transfer of investment manager during the year, with subsequent rebalancing of the investments.

Securitisations

The Society does not hold any investments in securitisations.

A.4 Performance of other activities

Courts

The Society has 189 branches ('Courts') which are the local point of contact for members. The Courts have assets amounting to £85.0m (2018: £83.5m) and table below provides the allocation of these funds.

Allocation £'000	2019	Restated 2018
Court Investment Fund property	44,960	53,326
Leeds Investment Association deposits	12,278	10,918
Fixed interest	18,213	7,930
Derby Investment Association deposits	4,499	4,222
Locally managed property	4,734	2,981
CIF Cash and cash equivalents	531	1,351
Net Debtors/creditors	(728)	110
Guernsey insurance assets	(3,951)	(1,586)
Court Reserve Fund	(2,585)	(2,592)
Society Court Funds	**77,951**	**76,660**
Leeds Investment Association surplus assets	**7,086**	**6,882**
Consolidated Court Funds	**85,037**	**83,542**

The fall in Court Investment Fund property assets is due to a program of disposals rather than a fall in market value.

The Society also manages a number of Discretionary Benefit Funds amounting to £14.4m (2018: £13.5m) which provide non-insurance benefits to members and Courts at the discretion of the Board of Directors of the Society.

The Courts are geographical groups of members who manage their own funds and support social, fraternal, educational and benevolent activities. Each Court elects its own officers and delegates who represent the Court's members at the High Court (Annual General Meeting) of the Society. The delegates attending High Court elect a High Chief Ranger each year to represent all Courts at internal and external events. This approach provides a governance structure for members to have their say in an organisation which they own.

Court assets and the Discretionary Benefit Funds are not available to support the UK insurance business of the Society. Their assets and activities are shown within the Non-Technical Account in the Society's financial statements.

Investment Associations

21 Courts hold deposits totalling £9.1m (2018: £8.4m) in two Investment Associations. These Investment Association deposits are investments made by the Courts and Discretionary Benefit funds and consequently have no impact on the insurance results shown in the Technical Account.

Investment Associations are registered as Specially Authorised Societies under the Friendly Society Act 1974. The Investment Associations have their own constitutions or rules and are governed by Committees of Management that are independent to the Society's Board of Directors. The objective of these Investment Associations is to receive deposits of registered friendly societies and their branches and to invest the same for their benefit. Investment Associations are unincorporated associations registered in England and Wales, have no issued share capital and their principal area of operation is Great Britain.

The Society is in a position where it can exert control over the Leeds Investment Association. The Leeds Investment Association's assets and liabilities and its income and expenses are therefore included in the consolidated financial statements, and the Leeds Investment Association assets and liabilities are recognised in the Solvency II balance sheet.

The rules of the Derby and Derbyshire Foresters' Investment Association state that the members of the Association are individuals who are members of the depositing courts and not the Courts themselves and this Association is not consolidated in the Society's financial statements.

Non-Profit Fund

The Society's Non-Profit Fund ('NPF') comprises those assets not allocated to any of the Society's with-profits, Court or Guernsey funds or and is available to support all other funds as the Board shall decide after taking advice from the Chief Actuary.

The NPF holds technical provisions which are included within the Technical Account of the Society's financial statements. The NPF technical provisions cover the Society's conventional non-profit and unit linked business, as well as expense liabilities that are not charged to other parts of the Society.

The NPF supports solvency capital requirements and is also used to meet business risks as determined by the Board.

Non-Technical Investment Returns

The investment returns below relate to the assets held by the Society's Courts and the Discretionary Benefit Funds. The 'Society' column below consists of the Court operations including Guernsey Court's general insurance business. The 'Group' (i.e. consolidated) column also includes the results of the Leeds Investment Association.

All figures in £000s	2019		Restated 2018	
	Group	Society	Group	Society
Investment income				
Income from property investments	3,860	3,463	3,348	3,018
Income from listed investments	503	101	595	230
Income from other investments	79	-	72	-
Sub-total income	**4,442**	**3,564**	**4,015**	**3,248**
Gains/(losses) on the realisation of listed investments	177	177	(261)	(261)
Gains/(losses) on the realisation of property investments	4,766	4,766	4,844	4,852
Sub-total realised gains/(losses)	**4,943**	**4,943**	**4,583**	**4,591**
Court held assets:				
Income from property investments	146	146	146	146
Income from mainland Court investments	622	2,239	599	1,507
Other income – Courts	535	535	429	429
Gains/(losses) on realisation of investments	-	-	(22)	(22)
Sub-total Court-related investment income	**1,303**	**2,920**	**1,152**	**2,060**
Total Non-Technical investment income	**10,688**	**11,427**	**9,750**	**9,899**
Total Non-Technical unrealised gains/(losses) on investments	(2,517)	(4,464)	(4,686)	(4,162)
Unrealised gains/(losses) on Court investments	406	406	1,870	1,870
Total Non-Technical investment returns	**8,577**	**7,369**	**6,934**	**7,607**
Non-Technical Investment management expenses and charges	416	416	369	369

2018 results have been restated to reflect a revaluation of Leeds Investment Association property.

Non-Technical Expenses

Non-Technical Account expenses of £416k (2018: £369k) relate to the investment costs of the Courts' investments.

A.5 Any other information

There is no other material information to disclose regarding the business and performance of the Society.

B. System of Governance

B.1 General Information on the System of Governance

This section outlines how the Society is directed and controlled and provides an overview of the Society's system of governance. The Society voluntarily complies with The AFM Corporate Governance Code ('Code') which is based on The UK Corporate Governance Code, as published in January 2019. The Code draws on good practice and on statutory and regulatory expectations.

The Board of Directors

The Board of Directors is the governing body of the whole of the Society's activities. The Board is responsible for the direction and management of the business of the Society in the fulfilment of its mission and strategic objectives, and in compliance with the Society's Memorandum, Rules and any applicable legislation and regulation and the Society's policies, principles and values.

In pursuance of its strategic objectives, the Board maintains a schedule of matters specifically reserved for the Board and exercises all those powers that are not by regulation, legislation, or by the Rules, required to be exercised by the Society at the Annual General Meeting or a Special General Meeting.

The composition of the Board at the end of 2019 was a mix of three Non-Executive Professional Directors, two Non-Executive Member Directors and two Executive Director (the Chief Executive Officer on an interim basis) and the Chief Financial Officer. A 'Professional Director' is identified as having recent insurance industry knowledge and experience, and a 'Member Director' is one drawn directly from the membership, having knowledge of the Society's fraternal activities.

The Board delegates certain parts of its responsibilities to Sub-Committees and to Advisory Arrangements which operate within defined Terms of Reference. The Terms of Reference are available on the Society's website at www.forestersfriendlysociety.co.uk/governance.

Chairman and Chief Executive

The roles of the Chairman and Chief Executive are held by different people and the division of responsibilities between the two is clearly established, set out in writing and agreed by the Board of Directors.

The Chairman is a Non-Executive and responsible for leadership of the Board, encouraging open and constructive debate at Board meetings, ensuring the Board acts effectively and within its Terms of Reference.

The Chief Executive has overall responsibility for managing the Society and for implementing the strategies and policies agreed by the Board.

Non-Executive Directors

The Non-Executive Directors are responsible for bringing independent judgement and challenge to the Board debate and its decisions. They provide constructive challenge to management and help develop proposals on strategy.

Copies of the letters of appointment of the Non-Executive Directors are available at the Society's Head Office.

Executive Directors

Two Executive Directors were in post at the end of 2019, Erik Vynckier, Interim Chief Executive Officer, and Rachel Hardy, Chief Financial Officer. From 1 January 2020, the roles of Chief Executive and Chief Financial Officer were merged. Rachel Hardy's regulatory approval for this merged role is awaited.

Senior Independent Director

The Code recommends that mutual insurers maintain a dialogue with their members and appoint a Senior Independent Director to handle issues and concerns raised by members. The Senior Independent Director acts as the Society's Whistleblowing Champion, provides counsel for the Chairman and serves as an intermediary for the other Directors when necessary. The Senior Independent Director is also responsible for holding annual meetings with the Non-Executive Directors, without the Chairman present, to appraise the Chairman's performance.

Appointments to the Board and Re-election

The appointment of new Directors is considered by the Nominations Committee which makes recommendations to the Board. Following co-option to the Board, a Director is subject to election by members at the next Annual General Meeting. Thereafter, in accordance with the Society's Rules, each Director must retire at the Annual General Meeting three years after the meeting at which they were last elected or re-elected as a Director. A retiring Director may seek re-election subject to the Society's Rules and the Code. A Director's initial term of office may be reduced to align with Board rotation.

Appraisal and Evaluation

The Board undertakes a formal annual evaluation of its own performance and that of its Committees and individual Directors, and in accordance with the Code is required to consider having a regular externally facilitated Board evaluation.

Sub-Committees of the Board

Audit, Risk and Compliance Committee ('ARCC')

The ARCC considers matters in relation to internal and external audit and is provided with reports on significant findings and recommendations, together with management's responses. It also considers and recommends the methodology and assumptions for the Solvency II technical provisions.

The ARCC provides advice to the Board on risk strategy and risk appetite, including the oversight of current risk exposures of the business. It develops proposals for the Board in respect of overall risk appetite and tolerance, as well as the metrics used to monitor the firm's risk management.

The Chief Executive Officer (incorporating the responsibilities of the Chief Financial Officer), Chief Risk Officer (CRO), internal auditors and external auditors attend meetings of the ARCC by invitation. The ARCC also invites other departmental managers as necessary to provide a deeper insight into key issues.

The ARCC, in accordance with their Terms of Reference, considers whether the annual Report and Accounts, taken as a whole, are fair, balanced and understandable, providing the information necessary for members to assess the Society's performance, business model and strategy.

Investment Committee

The Investment Committee considers matters in relation to investment of funds managed by the Society. Investment advice is given to the Investment Committee from the Society's Chief Investment Officer ('CIO'). The CIO also holds the Climate Change SMF role for the Society.

The performance of the various asset classes and funds is reviewed on a quarterly basis to ensure that they are in line with expectations and risk appetite.

Membership Committee

The Membership Committee considers matters in relation to the membership of the Society and the Society's non-regulated activities.

The main function of the Membership Committee is to promote active Forestry, as well as act as a conduit between the Board of Directors and the total membership, and to ensure the Society's non-regulated activities are relevant to members' needs and that they add value to the membership of the Society.

Nominations Committee

The Nominations Committee recommends to the Board suitable candidates for positions on the Board and the roles of Senior Independent Director, High Chief Ranger, High Sub-Chief Ranger and members of the Membership Committee. It also makes recommendations to the ARCC in respect of the appointment and termination of the Chief Risk Officer.

The Committee considers key person dependency and succession planning for the Board, role of Chief Executive and other senior management positions. It also considers the composition of the Sub-Committees reviewing the balance of skills, experience, independence and training of the Board.

Remuneration Committee

The Remuneration Committee considers matters in relation to remuneration and expenses.

The Committee supports the Board in the design and content of the Society's overall Remuneration Policy and reviews it regularly, in line with market conditions and applicable legislation.

The Committee determines and advises the Board on the policy for remuneration of the Executive Director and Company Secretary.

It also makes recommendations to the Board on Propositions to be proposed at the AGM, as well as the framework for remuneration of the Chairman, Non-Executive Directors, membership and Chairmanship of Sub-Committees, High Chief Ranger and High Sub-Chief Ranger.

With-Profits Advisory Arrangement

The With-Profits Advisory Arrangement ('WPAA') provides independent judgment to the Board including consideration of the rights and interests of with-profits policyholders and other policyholders, stakeholders and members of the Society, in a way that is consistent with the fair treatment of customers.

The Society has one open with-profits fund (the OIF) and four closed with-profits funds: Pure Endowment Fund ('PEF'), Tunstall Fund, Leek Fund and Post Office Insurance Society Fund ('POIS') Fund. Although each fund is considered individually, the main terms of reference are the same for all funds.

The WPAA, taking the advice of the With-Profits Actuary, considers the areas where management can exercise discretion in complying with the Principles and Practices of Financial Management ('PPFM') set out for each of the five with-profits funds in all material respects.

The PPFMs are available on the Society's website at www.forestersfriendlysociety.co.uk/about-us/reports-governance.

Unit-Linked Advisory Arrangement

The role of the Unit-Linked Advisory Arrangement ('ULAA') is to provide independent judgment to the Board including consideration of whether the management of the Society's unit-linked funds is consistent with the fair treatment of customers.

The Society has three unit-linked funds in operation: the POIS Flexible Growth Fund, the POIS Money Bond Fund and the POIS Savings Fund. The POIS Money Bond Fund is a closed fund.

The ULAA reviews and recommends to the Board any changes to the public document entitled 'How we manage our unit-linked funds' (available on the Society's website at www.pois.co.uk/about-us/about-our-funds). This document helps explain to customers how the funds will be operated and how the exercise of discretion may occur in relation to deriving unit-linked fund prices for use in working out policyholder benefits.

The WPAA and ULAA are advisory in nature; they are not decision-making bodies.

Key Functions

The following section provides a summary of the authority, resources and operational independence of the key functions.

Chief Risk Officer ('CRO')

The Risk Function is led by the CRO. The CRO is a senior role within the Society and is approved under the Senior Managers and Certification Regime ('SM&CR'). The CRO is a member of the Business Risk and Compliance Committee ('BRCC') and reports directly to the Chief Executive, with a dotted line to the ARCC Chair. The CRO is supported by a Risk & Compliance Assistant.

The CRO provides independent oversight and challenge of the Society's systems and controls in respect of risk management and ensures the adequacy of risk information, risk analysis and risk training provided to the Board. The role has responsibility for oversight of the Risk Management Framework and performance of the Society's Own Risk and Solvency Assessment ('ORSA').

The CRO is invited to attend Board and Committee meetings where relevant and provides reports to the ARCC.

Chief Actuary

The Chief Actuary is a Fellow of the Institute of Faculty of Actuaries and holds a practising certificate and is approved under the SM&CR. The Chief Actuary is supported by a team of qualified and part-qualified actuaries.

The Chief Actuary is responsible for the work of the Actuarial Function, particularly in respect of the calculation of technical provisions and solvency capital requirements. Key actuarial reports are presented to the ARCC.

The Chief Actuary is invited to attend relevant Board and Committee meetings where relevant. An annual report is produced for the Board, setting out all tasks that have been undertaken by the Actuarial Function and their results, with clear identification of any deficiencies and recommendations as to how these should be remedied.

The Chief Actuary role was outsourced to Alexandra Kim Durniat, Partner, Insurance Actuarial Practice, of Barnett Waddingham LLP, with internal oversight provided by the Chief Financial Officer during 2019 and up to 9 March 2020. In October 2019, the Board approved for the Chief Actuary role to be brought back in-house. The current Head of Actuarial was assessed as competent for the role and regulatory approval was received on 12 March 2020.

Chief Compliance Officer ('CCO')

Compliance Oversight is led by the CCO and is approved under the SM&CR. The CCO is a member of the BRCC and reports directly to the Chief Executive, with a dotted line to the ARCC Chair. The CCO is supported by a Risk & Compliance Assistant.

The CCO is appropriately skilled in respect of the regulatory environment, data protection, financial crime and monitoring. The CCO is also not involved in the day to day running of operations of the Society.

The CCO is invited to attend Board and Committee meetings where relevant and provides reports to the ARCC. The Compliance Plan sets out the planned activities of the Compliance Function considering the activities of the Society and its exposure to compliance risk.

Climate Change Officer

During 2019, the Society was required to designate a Climate Change Officer. This role has been taken up by the Society's Chief Investment Officer as a considerable amount of the financial risk the Society is exposed to in relation to climate change is derived from our investment portfolios.

Regulators are increasingly focusing on the risks that arise from climate change, and expect firms to work towards managing them, including the ability to remain operationally viable in changing times. The Society's investment manager AXA IM has been a leader in de-carbonisation, a leader in UN Principles for Responsible Investment (PRI) and our mandates are Environmental, Social and Governance (ESG).

The Society is taking steps to ensure that it will have the required processes in place to comply with all regulatory obligations related to climate change. A plan has been developed to cover the key aspects of Governance, Risk Management, Scenario Analysis and Disclosure. The main risk exposure to the Society is in respect of the investment portfolio. The Society's Chief Investment Officer is actively working with the Society's investment managers on our approach to climate change.

Other considerations and risks that are being assessed in respect of climate change are impacts of increased possibility of pandemics and impacts to properties held by the Society, whether this is flooding or natural disaster risks, and also increased risk of disaster that could affect the building that the society operates its insurance business from, and how the Society responds to those potential risks. Although the main risk exposure is the investment portfolio, the Society needs to ensure it remains operationally viable.

Internal Audit Function

The Internal Audit Function is currently outsourced to Mazars LLP, who reports directly to the Chair of the ARCC. The ARCC has access to a wide skill set using Mazars. Internal Audit maintains independence as the internal audits are conducted by an outsourced external company who are removed from the day to day operations of the Society. The annual internal audit plan is developed on a risk-based approach, taking into account the resources and skills required to carry out the plan.

The Chair of the ARCC has responsibility for the establishment, implementation and maintenance of the internal audit plan, taking into account all of the Society's activities and the complete system of governance. Written recommendations are presented to the ARCC based on the results of the audit findings.

Changes to the system of governance in the reporting period

The number of Executive Directors was reduced from three to one with the role of Chief Executive Officer and Chief Financial Officer being merged into one role and the redundancy of the Membership Director role.

In January 2020, the in-house actuarial team was outsourced. The Society commenced bringing the role of Chief Actuary back in-house and transferring the role of With Profits Actuary from Barnett Waddingham LLP to Zenith Actuarial Limited. There was an addition of the SMF responsibility for climate change.

Assessment of adequacy of the system of governance

The Board consider that the system of governance is appropriate for the Society based on consideration of the nature, scale and complexity of the risks inherent in its business.

Remuneration Policy

The Society's Remuneration Policy aims to attract, motivate, support and retain high quality individuals with the necessary skills to achieve the Society's strategic objectives, meet regulatory requirements and support the short, medium and long-term interests of members. The Society monitors its gender pay gap.

The scope of the Policy covers all elements of the remuneration package for staff, Executive and Non-Executive Directors (including the Chairman, Deputy Chairman and Senior Independent Director), members of Board Sub-Committees and roles within the Society which are of a presidential nature such as the High Chief Ranger.

The Policy forms part of a risk framework supporting the Board and management in discharging their responsibilities to ensure that:

- remuneration awards do not threaten the Society's ability to maintain an adequate capital base;
- remuneration arrangements with service providers do not encourage risk taking that is excessive in view of the Society's risk management strategy; and
- failure is not rewarded.

The Board and Remuneration Committee are primarily responsible for determining the Policy and reviewing it annually to ensure it remains appropriate. The Board retains the discretion to make changes in response to market conditions and in exceptional circumstances, where it is in the interest of the Society and its members to do so.

The outcome of any assessment by the Remuneration Committee will be reported ultimately to the Board with any actual and potential risks being reported to the Chief Risk Officer as part of the management of risks across the whole Society.

The Society operates a defined contribution group stakeholder pension scheme which employees are eligible to join after a probationary period with auto-enrolment. Prior to 2003, employees were eligible to join one of the Society's defined benefit pension schemes. There are no supplementary pension benefits or early retirement schemes for members of the Board or other key function holders.

The remuneration budget is usually aligned with consumer price inflationary indices as published by the Office of National Statistics and with reference to the living wage rate published from time to time.

Executive remuneration comprises of basic salary, a contributory pension and other benefits.

The remuneration of all Non-Executive Directors, including the Chairman, is reviewed on an annual basis using expert advice and guidance from both internal and external sources. Non-Executives are only entitled to fees and expenses, and do not participate in any performance-related pay schemes or receive any pension arrangements or other benefits.

Post holders to the roles of High Chief Ranger and High Sub-Chief Ranger are only entitled to fees and expenses during their term of office, and do not participate in any performance related pay schemes or receive any pension arrangements or other benefits.

Any proposed change in fees for Non-Executive Directors, the membership and Chairmanship of Sub-Committees, the High Chief Ranger or High Sub-Chief Ranger is determined by the Board and presented as a Proposition for approval by the delegates at the next Annual General Meeting.

The Society defines substantial variable pay as 25% or more of base salary. All bonus payments made by the Society to employees who are not Executive Directors are below 25% of base salary.

Where the Society considers making the payment of a substantial bonus, the following points are considered:

- is the person to whom the bonus applies at or above Level 2 management;
- a substantial variable pay scheme needs to be linked/referenced to risk tolerance and business strategy i.e. no reward should be given for risk taking outside the stated risk tolerance of the Society;
- there needs to be the possibility of a nil pay-out;
- a substantial portion would be deferred for a period of not less than three years;
- application of malus; and
- compliance with stated risk tolerance.

The CCO, CRO and Chief Actuary do not participate in a substantial bonus scheme based on quantitative performance.

Material transactions

There have been no material transactions conducted during 2019 between the Society and members of the Board or key function holders.

B.2 Fit and Proper requirements

Members of the Board and Senior Management provide strategic leadership that influences the financial position and future direction of the Society. As such, persons in these positions are required to possess certain qualities including integrity, credibility and relevant competencies. Annual reviews are undertaken to ensure this standard is met.

The Society has a Fit and Proper Policy which sets out how it meets the regulatory requirements for persons who have key functions to be Fit and Proper.

The scope of the Policy covers the assessment of the fitness and propriety of the persons who effectively run the Society or have other key functions, both when being considered for the specific position and on an ongoing basis. The assessment covers the honesty and financial soundness based on relevant evidence regarding their character, personal behaviour and business conduct including any criminal, financial and supervisory aspects regardless of jurisdiction. The period of limitation of the committed offence is judged based on national law or practice.

An assessment is carried out using a Fit and Proper questionnaire prescribed by the Society's regulator on initial appointment and where appropriate, submitted to the said regulator as part of the approval process.

The Chief Executive is responsible for ensuring the Society meets its Fit and Proper requirements in accordance with the Society's Responsibilities Map. The Chief Executive may choose to delegate the undertaking of the Fit and Proper assessments to the Company Secretary but will have overall responsibility.

The Society determines whether any other employee who is not subject to the regulatory approval process, should also be assessed against the Fit and Proper requirements laid down by the Society, on a case-by-case basis.

Failure to meet one element of the Fit and Proper questionnaire does not necessarily mean failure to meet the requirements. Considerations will be made of the specific surroundings, including the lapse of time, potential risks posed to the Society, degree of influence the specific role will attract or new conflicts that could impair the individual's performance in the position.

The Fit and Proper assessments are supported by relevant information. Where significant reliance is placed on information that is obtained from the person being assessed, and that information is material to the determination of the person's fitness and propriety, the Society takes reasonable steps within permissible written laws to verify the information against independent sources.

Where the Society outsources a key function, it ensures that the service provider applies the Fit and Proper assessment of persons employed by them to perform the specific role. The Society designates a person with overall responsibility for the outsourced key function that is Fit and Proper and possesses sufficient knowledge and experience regarding the outsourced key function to be able to challenge the performance and results of the service provider.

An assessment is also carried out at regular intervals, at least annually, or whenever any key responsible person's fitness and propriety is or might be materially compromised. Situations which if they arise would lead to a reassessment of the Fit and Proper status include:

- if the approved person breaches any of the regulatory principles and practices which approved persons are required to follow, or
- if the approved person commits an act of gross misconduct under the Society's Internal Policies and Procedures.

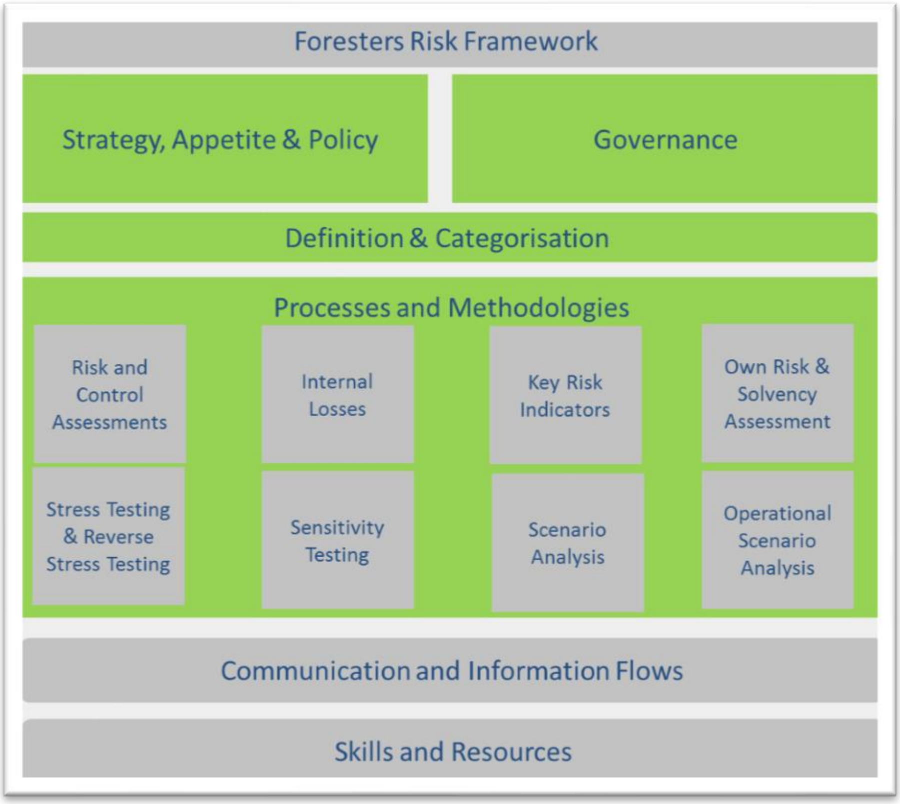
The outcome of any assessment would be reported to the Board with any actual and potential risks being reported to the CRO as part of the management of risks across the whole Society.

B.3 Risk management system

The Society's Board has ultimate responsibility for management of risk across the Society. The Board is responsible for approving the risk strategy and risk appetite for the Society, reviewing and approving the ORSA Report, ensuring an effective Risk Management Framework and Risk governance model is in place.

Risk Management Framework

The Society operates the below Risk Management Framework which brings together the risk management strategy, governance, processes and reporting.



The Society's Risk Management Framework is overseen by the CRO and is reviewed annually. Changes to the framework are approved by the ARCC.

The objectives of the framework are to:

- align strategy, capital, processes, people, technology and knowledge to enable the management of opportunities, uncertainties and threats in a structured manner;
- establish a common view of risk across the Society and an understanding of the risks inherent within the business;
- ensure the Society's view of risk is current and in line with risk appetite;
- improve decision making;
- provide relevant and accurate management information;
- ensure adequate and appropriate resources are available to facilitate effective governance and challenge;
- ensure clear accountability; and
- promote and embed a risk-aware culture.

Key areas of the Society's risk management framework are described below.

Risk Strategy

Risk strategy is the process of acknowledging actual and potential threat as to the successful delivery of objectives, and determining the activities required to minimise or eliminate them. This forms part of the longer-term business strategy. The Society's risk strategy is intended to have a lifespan of three to five years and is aligned with the business strategy. By acting in accordance with the following high-level preferences, the aim is to enhance overall capital efficiency and returns:

- Foresters is a Friendly Society in the business of taking on risks in the course of providing financial solutions for members, where they can be managed efficiently.
- Foresters will focus on risks where it is believed it can provide value to members, and for which members are willing to pay the appropriate amount. These are primarily insurance and investment risks.
- As a Friendly Society, risks are only taken that we are rewarded for and where the appropriate skills are available to manage this. Risks that expose the Society to very volatile or extreme potential outcomes which would threaten our ability to continue, are avoided.
- The Society will:
    - produce and implement a risk management policy;
    - validate business objectives and assumptions;
    - identify significant risks and the associated controls required;
    - have in place adequate and proportionate risk management processes;
    - employ Resources to provide support to the Society's risk management activities; and
    - perform annual exercise reviewing the Society's Risk Appetite.

The risk strategy will be reviewed on an annual basis to ensure continued alignment to the overall business strategy.

Risk Appetite and Limits

The Society's risk appetite supports the delivery of the risk strategy. It is the level of risk the Society is prepared to take whilst pursuing its business strategy. The risk appetite is determined by the Board. The Board also determines the risk tolerance from the stated risk appetite which provides a framework to apply risk limits and actions. Management monitors the Society's risk profile against the risk appetite and reports this to the Board.

Risk Policies

The Society has in place risk policies that set out the requirements for the management of the Society's risks along with the risk management framework. These policies are reviewed on an annual basis.

Risk Identification, Monitoring and Reporting

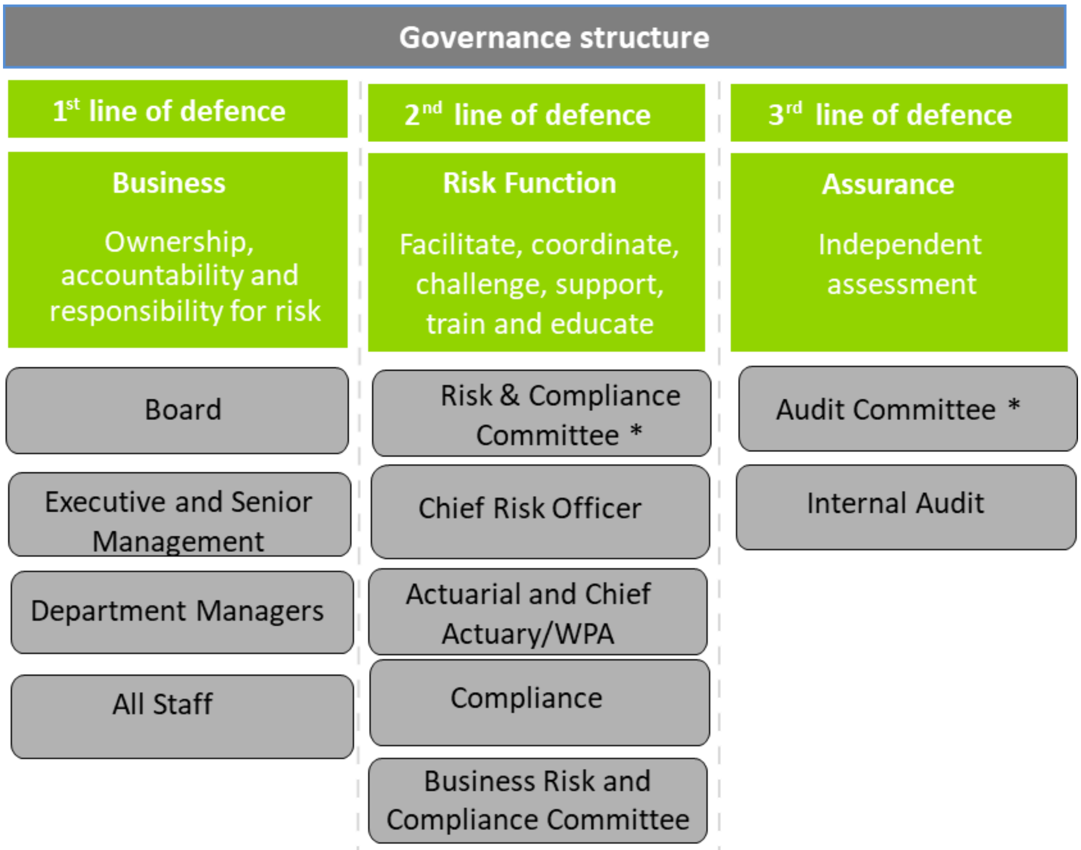
The Risk function maintains the risk management system and oversees the implementation of requirements of the risk framework. All material risks are identified, assessed and monitored. A Risk and Control Assessment process is in place supported by identification of risks through stress testing for financial risks, business risks and insurance risks. Individual risks are assigned to and owned by a specified individual within the Society.

All risks identified are assessed against a matrix for probability of occurrence and financial and non-financial impact. Emerging risks are also identified and monitored and are part of the risk reporting process.

The BRCC assess the top risks on a quarterly basis and report change in Risk exposures to the ARCC.

Risk Governance

The Society's risk governance model is designed to promote transparency, accountability and consistency through the clear identification of roles, the separation of Society management and governance and control structures. Oversight of the Society's operation is provided using the ''three lines of defence'' approach. Details on roles and responsibilities by risk type are documented in the Society's Risk Management Policy.



The combined Audit, Risk and Compliance Committee separates Risk and Audit related matters by segregating the agenda to ensure clarity on risk and audit areas, and ensuring the Non-Executive Director members taken together have the appropriate skills to address both Risk and Audit matters.

The responsibilities of the key functions within the three lines of defence model are explained in the Key Functions part of Section B.1.

Own Risk and Solvency Assessment ('ORSA')

A key element of the Society's Risk Management Framework is the ORSA. The ORSA is the set of processes and procedures in place to identify, assess, monitor, manage and report on the short and long-term risks that the Society faces, or may face in the future, and to determine the own funds necessary to ensure that overall solvency needs are met at all times.

The ORSA report is owned by the Board and supported by the ORSA Policy and ORSA processes. It details the main risks faced by the Society and the governance and processes in place to enable the Board to understand and manage them. The Society's Business Plan is used as a feed into the ORSA process to support future decision making from a risk and capital management perspective. In approving the annual ORSA report, the Board acknowledge the need to give due consideration to the outputs and conclusions of the continuous ORSA processes when making risk-based decisions over the coming year.

The Society's ORSA Policy sets out the overall aim and approach to be taken for the ORSA, together with the standards and parameters which must be adhered to, the escalation procedures, reporting requirements, responsibilities and frequency.

The Policy is designed to be appropriate and proportionate for the Society and compliant with regulation. The ORSA processes are designed to be auditable, repeatable and subject to the appropriate levels of documentation appropriate to meet the objectives of Solvency II.

ORSA Processes

The ORSA report identifies and assesses both the risks included in the calculation of the Solvency II SCR and the non-quantifiable risks which are part of the risk profile.

The objectives are to:

- define established principles for the ORSA process to comply with Solvency II regulations and embed effective risk management throughout the Society;
- ensure the ORSA process is aligned to both the Business Planning process and the Strategic Planning process;
- allocate roles, responsibilities and ownership to the Board, Committees, Senior Management, Management and Staff;
- promote a consistent and effective use of the ORSA framework across the Society;
- define and communicate ORSA processes and procedures to the Board of Directors and the wider company;
- produce effective ORSA documentation to be used by management in decision-making processes and for external disclosure;
- define requirements for evidence and reporting to demonstrate the methods applied; and
- conduct a consistent prospective assessment of the Society's risk and capital requirements, both in normal and stressed environments, throughout the business plan period.

The Board has ownership and the ultimate responsibility for the ORSA process and report, including the appropriateness and completeness of the processes and procedures, and approval of the disclosures. The Board has an active role in:

- Review and approval of the ORSA Policy;
- Providing a steer on the design and content of the ORSA process;
- Setting the Risk Appetite;
- Challenging risk identification and mitigation;
- Approval and communication of the ORSA report.

The schedule of Board meetings across the year allows sufficient time for discussion of the different elements of the ORSA process.

The ORSA process considers strategy and risk over the business plan period. This includes:

- significant changes in risk profile and risk exposure;
- external factors and/or future changes in economic and political conditions;
- change in the legal or regulatory environment;
- any significant management action;
- new product development and design; and
- other qualitative assessment on a longer-term horizon.

Stress and Scenario Testing

Stress and scenario testing, including reverse stress testing, is carried out annually alongside the best estimate projections to understand the potential impact of certain events over the business plan period. These scenarios cover bad Brexit and pandemic. This allows the Board to review and challenge the Business plan on a forward-looking basis. The results are used as part of the broader risk assessment framework, to incorporate relevant management or mitigating actions and to help develop contingency planning. Qualitative scenarios are also considered on Cyber Security threats, Brexit implications and cost saving actions.

Reverse stress tests are considered to identify and assess the scenarios most likely to cause the current business model to fail and/or lead its stakeholders to lose confidence in the organisation. Mitigating actions can be considered and put in place as appropriate. During 2019 the Society considered a number of extreme operational events, pandemic sickness scenario, a new global economic crisis, civil unrest in Northern Ireland in relation to the Society's group scheme.

ORSA Communication

The conclusions of the ORSA process are communicated through circulation of the ORSA report to selected staff, a summary update to the management team as part of monthly management meetings and, as appropriate, through quarterly staff briefings.

Frequency of the ORSA

The ORSA process is undertaken on an annual basis aligned to the Strategy and Business Planning process to ensure informed risk and capital-based decisions are made to protect the sustainability and long-term viability of the Society.

The full ORSA process will also be undertaken if there are any significant events that could have an impact on the ability of the Society to achieve its business plan. As set out in the ORSA Policy, a significant change would be:

- potential acquisition/merger;
- major strategic changes in distribution and/or product offerings;
- collapse of financial markets; or
- significant strategic projects.

Basis of the ORSA capital assessment

The assessment of the appropriateness of the Solvency II Standard Formula is reviewed and updated annually given the Society's specific risk profile and features. The most recent review, which was approved by the Board in February 2020, demonstrated that the Standard Formula continues to be an appropriate basis for the calculation of the Society's SCR.

The approach and assumptions for the economic capital assessment in the ORSA report therefore only deviate from the Standard Formula approach in the following areas:

- **Equity Risk** – credit is taken for the Society's trigger point in limiting the reduction in asset values from a fall in equities. Under the standard formula, the stress is an instantaneous fall in equity values meaning the Society would not have the opportunity to exercise the trigger point management action.
- **Longevity Risk** – this has been extended to be applied to the two defined benefit pension schemes.
- **Operational Risk** – calculated using the Society's own methodology based on Society-specific scenarios.

The Capital Management Framework in conjunction with the ORSA outlines the overall aim and approach to be taken for capital management within the Society and forms part of the Society's Risk Management Framework. The objective of the Capital Management framework is to provide principles and standards for capital management to ensure that the Society has sufficient capital resources to remain solvent on both a statutory (regulatory) basis and an economic basis.

The Capital Management Framework is maintained by the ARCC, which is responsible for monitoring its effectiveness in maintaining an appropriate level of capital resources.

B.4 Internal control system

Internal control system

The Society's internal control system aims to ensure financial reports are reliable, the society operates effectively and efficiently, and our activities comply with applicable laws and regulations.

The Society has in place standards, processes and structures as a basis for carrying out internal controls across the company. The Board has overall responsibility for ensuring that an adequate and effective control system exists. Internal Control forms part of the Risk Management Framework. All key risks are identified and documented, controls both manual and automated are put in place to address these risks and they are designed as preventative or detective.

The ARCC reviews the effectiveness of the Society's internal controls and is responsible for understanding the extent of both internal and external auditors' review of internal control over financial reporting disclosures. On an annual basis the ARCC will review the adequacy of the Risk Management and Internal Controls system.

The Society has a number of control policies in place that cover Risk, Compliance, Human Resources and Information Technology. The policy review process ensures that there is a framework for the documentation and oversight of annual and periodic policy reviews.

The Society has no appetite for regulatory breaches. Compliance monitoring provides assurance that the business is managing its regulatory risk exposure appropriately and that controls are effective. It is a key mechanism in confirming that the business is complying with agreed policies and meeting regulatory responsibilities.

Compliance function

The Compliance function seeks to be a trusted advisor to the business, supporting the strategies set out by the Board whilst ensuring that regulatory obligations are met. It helps to ensure that the Society's behaviours and activities are in the members' interests and that the Society acts with integrity in areas such as product launches, marketing and strategic initiatives.

The Society employs a Chief Compliance Officer who also performs the roles of the Money Laundering Reporting Officer and Data Protection Officer. The Chief Compliance Officer reports directly to the Chief Executive and a dotted line to the Chair of the ARCC. The Chief Compliance Officer is supported by a Risk & Compliance Assistant.

External resource is used to provide expertise as required. The Compliance Manager is invited to attend Board Sub-Committee meetings where relevant and provides information and reports to the ARCC on key regulatory areas.

The annual Compliance Plan is approved by the ARCC and involves a programme of reviews targeted on the business areas and issues which give rise to the highest potential risk of customer detriment, regulatory censure or reputational damage. Particular focus is given in response to regulatory thematic reviews.

The main roles of the Compliance function are to:

- ensure there is a good understanding of the regulatory requirements and the regulatory environment in which the Society operates;
- help identify and evaluate regulatory risk and advise on ways to manage and mitigate risk to protect the Society and its members;
- track, assess and communicate the impact of new regulation in a way that is tailored to the business of the Society;
- advise on the design and implementation of controls;
- monitor and challenge the behaviours and controls in place to promote the compliance culture; and
- maintain the Society's Responsibilities Map.

The Compliance function is responsible for managing regulatory requests and onsite visits, ensuring there is a central point of contact with a clear understanding of the regulators' approaches and the standards to which the Society is held to account. The Chief Compliance Officer maintains awareness of all issues and communications with the various regulatory bodies.

Financial crime risk is also the responsibility of the Compliance function, covering fraud, bribery and corruption, money laundering, terrorist financing and sanction breaches. Advisory and monitoring tasks are carried out in relation to the financial crime risks both within the business and in relation to third parties on whom reliance is placed or to whom activities are outsourced.

B.5 Internal Audit function

The Internal Audit function is a key part of the assurance cycle for the Society in informing and updating the risk profile of the organisation. The Internal Audit function report directly to the Chair of the ARCC. The ARCC review and approve the annual internal audit plan. Internal Audit provides the Board and management with assurance on whether the Society's risk management, control and governance processes are adequate and operating effectively to protect the assets, reputation and sustainability of the Society. The Internal Audit function have unlimited access to the Society's information and premises to allow them to carry out their role effectively.

The Internal Audit function is able to maintain its independence and objectivity from the activities it reviews as the external staff from Mazars that carry out the audits are independent from the Society staff that work in the areas under review. No direct responsibility for operational activities are held by the internal audit function.

B.6 Actuarial function

The Society outsourced the Chief Actuary role to Kim Durniat of Barnett Waddingham for the full year 2019, up to 9 March 2020. The current internal Head of Actuarial took on the role of Chief Actuary and regulatory approval followed on 12 March 2020. The Chief Actuary role reports to the Chief Financial Officer.

The Chief Actuary is responsible for the work of the Actuarial function, particularly in respect of:

- the calculation of technical provisions;
- the appropriateness of the methodologies and underlying models used, as well as the assumptions made in the calculation of technical provisions;
- assessment of the sufficiency and quality of data used in the calculation of technical provisions;
- comparison of best estimates against experience;
- inform the Society's governing body of the reliability and adequacy of the calculation of the technical provisions;

* express an opinion on the overall underwriting policy and adequacy of reinsurance arrangements of the Society; and
* contribute to the effective implementation of the risk management system through advice and guidance and in particular with respect to the risk modelling underlying the calculation of the Solvency Capital Requirement and Minimum Capital Requirement and to the Society's ORSA.

The Actuarial function submits reports to the Board setting out the tasks that have been undertaken, the results and any relevant recommendations.

The Society outsourced its actuarial team in January 2020 to Zenith Actuarial Limited.

B.7 Outsourcing

The Society recognises that outsourcing is a key element of its business model and that there are associated risks. The Outsourcing Risk Policy covers the Society's approach and processes for outsourcing from the inception to the end of the contract.

This Policy defines:

* the criteria for determining whether a function is a Key Outsourced Function;
* the criteria for selecting a service provider of suitable quality and how performance results are to be assessed;
* the details to be included in the written agreement with the service provider; and
* a requirement for business continuity plans, including exit strategies for outsourced critical or important functions or activities

The risks covered are as follows:

* the Society outsources to an outsourcer that is not competent to carry out the role required;
* damage to the interest of policyholders due to failure of the outsourcer to deliver the service required;
* regulatory risk, money laundering and data protection issues caused by failure to select a suitable candidate;
* reputational risk caused by events as described above; and
* financial risk consequent on the above risks

The following table identifies the Key Outsourced Functions set out in the Society's Responsibilities Map together with the Key Function Holder with oversight for each Key Function as at 31 December 2019:

Key Outsourced Function	Senior Manager / Key Function Holder
Internal Audit	ARCC Chair (SMF 11)
Climate change SMF role	Chief Executive (SMF 1)
Chief Actuary	Chief Finance (SMF 2)
With-Profits Actuary	Chief Finance (SMF 2)
IT and associated systems (infrastructure and hosting)	Chief Executive (SMF 1)
Investment Managers and Property Managers	Chief Finance (SMF 2)
Guernsey business outsourcing	Chief Executive (SMF 1)

All outsourced service providers are located in either the UK or Guernsey.

As discussed earlier in this report, the Society's Actuarial Function has been outsourced to Zenith Actuarial Limited, effective from 1 January 2020.

The examination of the potential service provider allows the Society to understand the main risks that might arise from outsourcing, to identify the most suitable strategies for mitigation or management of these risks and to ensure the service provider has the ability, capacity and any authorisation required by law to perform the outsourced activity. The Society remains ultimately responsible for the oversight, performance and service provided by the outsourced functions.

Contingency plans have been developed for all Key Functions outsourced by the Society, irrespective of the service provider's own contingency plans, that will allow for the transfer to a new service provider or the function being resumed internally.

B.8 Any other information

There is no other material information regarding the system of governance of the Society.

C. Risk Profile

The most significant risks to the Society are all captured under the Solvency II Standard Formula stress tests used to determine the SCR. The table below sets out the Society's market and underwriting risks for the Insurance and Court funds, as shown by the components of the SCR, as at 31 December 2019:

Sources of capital requirements (£m)					
Risk	**Insurance Funds**	**Guernsey**	**UK Courts**	**Total**	**Proportion of total**
Property	0.3	0.6	14.2	15.1	29.4%
Equity	1.6	0.9	7.3	9.8	19.1%
Expense & inflation	5.0	-	-	5.0	9.7%
Spread (Credit)	3.3	0.0	1.2	4.5	8.8%
Morbidity	4.2	-	-	4.2	8.2%
Lapse	2.8	0.0	-	2.8	5.5%
Counterparty Default	0.7	0.0	1.1	1.8	3.5%
Currency	1.1	0.0	0.6	1.7	3.4%
Mortality	1.7	-	-	1.7	3.2%
Operational	1.2	0.1	-	1.3	2.5%
Interest rate	0.7	0.0	0.5	1.2	2.3%
Longevity	0.8	-	-	0.8	1.6%
Morbidity Catastrophe	0.7	0.0	-	0.7	1.4%
Premium & Reserve Risk	-	0.4	-	0.4	0.8%
Mortality Catastrophe	0.3	-	-	0.3	0.6%
Concentration	-	-	-	-	-
Total pre-diversification	**24.3**	**2.2**	**24.9**	**51.4**	**100%**
Diversification*	(9.7)	(0.5)	(3.4)	(13.5)	
Total post-diversification	**14.6**	**1.7**	**21.5**	**37.8**	

* *Includes restriction on Loss Absorbing Capacity of Technical Provisions of £0.3m.*

The largest capital requirements for the Society's Insurance funds are in respect of increases in expenses, incidence and duration of morbidity, corporate bond spreads, lapse risk and mortality risk. For the Society's UK Courts and Guernsey, the largest capital requirements are in respect of property and equity market falls.

The table below compares the Society's capital requirements at the end of 2019 and 2018:

Capital requirements by risk (£m)	2019	2018	Movement
Property	15.1	16.7	(1.6)
Equity	9.8	10.7	(0.9)
Expense & inflation	5.0	5.0	(0.0)
Spread (Credit)	4.5	2.9	1.7
Morbidity	4.2	3.5	0.7
Lapse	2.8	2.2	0.6
Counterparty Default	1.8	1.8	(0.0)
Currency	1.7	0.7	1.1
Mortality	1.7	1.3	0.3
Operational	1.3	1.2	0.1
Interest rate	1.2	0.5	0.7
Longevity	0.8	0.8	0.0
Morbidity Catastrophe	0.7	0.7	(0.0)
Premium & Reserve Risk	0.4	0.4	(0.0)
Mortality Catastrophe	0.3	1.8	(1.4)
Concentration	-	-	(0.0)
Total pre-diversification	**51.3**	**50.1**	**1.3**
Diversification	(13.5)	(11.2)	(2.3)
Total post-diversification	**37.8**	**38.9**	**(1.1)**

The main changes over the year are summarised below.

- Spread risk increased by £1.7m, primarily due to an increase in fixed interest holdings within the UK Courts assets.
- Property risk reduced by £1.6m, primarily due to lower property holdings within the Guernsey and UK Courts funds.
- Mortality catastrophe risk reduced by £1.4m, primarily due to an increase in the level of catastrophe reinsurance cover for group schemes.
- Currency risk increased by £1.1m, primarily due to an investment into an overseas fixed interest private debt fund denominated in Euros.
- Equity risk reduced by £0.9m, due to a lower equity allocation and capital optimisation within the OIF, partly offset by an increase in the equity stress from a fall in the symmetric adjustment (regulatory adjustment to the equity stress).
- Morbidity risk increased by £0.7m, primarily due to the renewal of a large Group scheme in 2019.
- Interest rate risk increased by £0.7m, primarily due to larger holdings of fixed interest assets.
- Lapse risk increased by £0.6m, primarily due to the fall in risk-free rates of interest, increasing the value of long term guarantees and the cost of expense overruns.

Further details on the types of risk faced by the Society are given in Sections C1 – C6.

Prudent Person Principle

The Society is able to demonstrate, through a combination of activities and documentation, that the Prudent Person Principle ('PPP') is being used to govern investment decisions and asset allocation for its insurance funds. This includes evidence that the assets backing members' policies are:

- held in the best interests of policyholders;
- are consistent with policy aims; and
- are sufficiently liquid.

There are well-documented processes for decision-making and validation of data and information provided by third parties.

The Prudent Person Principle means that the Society:

- only invests in assets with risks the Society can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs;
- invests in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole;
- ensures localisation of assets such as to ensure their availability;
- ensures assets held to cover technical provisions are invested in a manner appropriate to the nature and duration of the insurance liabilities;
- invests in assets in the best interest of all policyholders and beneficiaries taking into account any disclosed policy objectives;
- will only hold prudent levels of assets which are not admitted to trading on a regulated financial market;
- properly diversifies asset holdings in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, or geographical area and excessive accumulation of risk in the portfolio as a whole; and
- does not expose itself to excessive risk concentration in assets issued by the same issuer, or by issuers belonging to the same group.

The main items of documentation are:

- PPFM;
- How we manage our unit-linked funds;
- Investment Committee Terms of Reference;
- WPAA and ULAA Terms of Reference; and
- Fund Manager mandates and reports - fund managers operate within the mandates defined by the Investment Committee and are responsible for short-term tactical positions together with specific stock selection. A summary of investment policy is produced for each fund and reports are provided to the Investment Committee on their activity and performance.

There are no changes required to any of the investment strategies or portfolios in order to comply further with the Prudent Person Principle.

Risk concentration

The Society is not exposed to any material risk concentrations. Concentration risk in respect of financial investments is discussed in Section C3.

Risk mitigation

The most material risk mitigation technique used by the Society is reinsurance to reduce the impact of a catastrophe affecting lives insured under our Group Schemes. The level of reinsurance cover was extended in 2019 to reduce the capital requirement in respect of mortality catastrophe risk. Reinsurance cover is approved by the Board. There are no other material applications of risk mitigation techniques by the Society. Future consideration of such techniques would include a requirement for regular assessment and documentation in the quarterly Risk Information pack supplied to the ARCC.

The risk mitigation techniques used by the Society consist of risk transfer, risk avoidance, risk reduction and risk termination. Risk reduction techniques include changes to investment strategy following a downturn in investment markets and changes to with-profits bonuses, managing the Society's cost of guarantee exposure.

The Board also conducts a reverse stress-testing exercise annually as part of the ORSA to identify and qualitatively assess the scenarios most likely to cause the Society's current business model to fail, and/or lead its stakeholders to lose confidence in the organisation. For each scenario, mitigating actions are identified to protect the Society from the full impacts.

Key Risk Indicators ('KRI') are used by the Society to enhance the monitoring and mitigation of key risks and identify trends to support risk reporting and escalation.

Risk sensitivity

The Society's stress testing approach to calculating capital requirements is supplemented by sensitivity and scenario testing as set out in the Stress and Scenario Testing Framework. Sensitivity testing is carried out as part of the business planning process, using less extreme events than those used for setting capital requirements. The Business planning process includes a range of sensitivity tests which are selected each year reflecting specific economic conditions and areas where the Society is seeking additional insight into the level of risk to which it is exposed. The sensitivity tests used in 2019 explored impacts to changes in levels of sales, expenses, assumptions including lapses and Group scheme claims loss ratio, and change in the risk-free reference rate from LIBOR to SONIA. Two qualitative sensitives were also considered for a decrease in total asset values and reduction in yields.

The ORSA process carried out during 2019 included consideration of a 30% equity fall sensitivity.

The Society's exposure to equities are primarily through the asset share in with-profit funds, the unit funds and from the pension schemes. The overall impact of the 30% equity shock is an 8% decrease in economic capital coverage ratio to 124%, compared with a 5% decrease last year. Although the risk appetite ladder is based on the Pillar 1 SCR, this suggests that the capital coverage ratio will remain in the Amber range.

Due to a reduction in OIF equity holdings, following the transfer to AXA IM, the impact on assets from the equity shock is lower than in previous years. The exposure comes from assets backing policyholder funds and a significant proportion of the fall in those asset values is absorbed by policyholder liabilities, therefore the fall in excess of assets over liabilities is reduced. Furthermore, the impact of an equity fall is also firstly absorbed by the OIF ring-fenced fund deduction, rather than being immediately impacting the Society's available capital resources.

The fall in available capital under this sensitivity has significantly reduced compared to last year. This is largely due to the capital optimisation activity within the OIF, whereby the fund better matches the assets to the fund's expense liabilities. Due to the ring-fenced fund deduction, the impact of this stress does not feed through into the Society's available capital resources.

Overall, this sensitivity has minimal impact on the SCR. Although the pre-diversified capital requirement on equity risk falls significantly, this is offset by an increase in SCR from the closed with-profit funds, where the discretionary benefits are insufficient to fully absorb all the risks inherent within the closed funds.

In carrying out this sensitivity, consideration has been given to the management actions set out in the Future Management Action Plan approved at the February 2019 Board meeting. The most relevant management action is the equity trigger points in the OIF, resulting to a fall in asset values that is slightly less than that implied by a 30% fall in equity values and that following this impact, the fund is de-risked to minimise future equity risk.

This results in a reduction in the equity backing ratio as rebalancing has not been assumed. If the equity shock was sufficient to trigger the equity sale management action, rebalancing would not occur in the short-term as no triggers have been set for equity repurchases.

Note, following the market falls since 2019 year-end, the equity management action has been triggered in full.

In addition to the sensitivity test of equity falls on the capital coverage for the Insurance Funds, the Society also carried out sensitivity testing on the impact on the technical provisions of all major risks.

C.1 Underwriting risk

The Society is exposed to life insurance and health insurance risks arising from both the perils covered and the processes followed in the conduct of the insurance business. The major areas of risk in this category that the Society is exposed to are expenses, morbidity and mortality.

Expense risk

The Society holds £5.0m (2018: £5.0m) of capital against expense and inflation risk before taking risk diversification into account. The capital held in respect of this risk has remained unchanged over the year.

Expense risk arises from the variation in the expenses incurred in servicing insurance contracts. This may be due to an increase in the monetary amount of expenses taken into account in the calculation of technical provisions, or an increase in the assumed future expense inflation rate.

The majority of the Society's expenses are incurred in staff costs, IT infrastructure and cost of land and buildings occupied. The projected expenses used in assessing the capital impact of expense and inflation risk are based on continuing tight cost control.

Disability/Morbidity risk

The Society holds £4.2m (2018: £3.5m) of capital against disability/morbidity risk before taking risk diversification into account. The capital held in respect of this risk has increased over the year due to a renewal of one large Group scheme.

Disability/morbidity risk is the risk of loss, or of adverse changes in the value of insurance liabilities, resulting from changes in disability and morbidity rates. It may occur due to either a large-scale event or a gradual increase in claim rates and fall in recovery rates.

The disability and morbidity risks faced by the Society are spread across both Group schemes and individual business. This provides a level of diversity in terms of likelihood of disability or sickness (inception rates) or change in the severity of disability or sickness (recovery rates). The Society's Group sick pay benefits is written with a 26-week deferred period, which reduces this risk to the Society.

As for life insurance, the initial health insurance underwriting is limited, but this is taken into account in the product design and the level and types of cover offered.

Lapse risk

The Society holds £2.8m (2018: £2.2m) of capital against lapse risk before taking risk diversification into account. The Society is exposed to a reduction in lapse rates. The capital held in respect of this risk has increased over the year due to the fall in yields, increasing the value of long term guarantees and the cost of expense overruns.

Lapse risk is the risk of loss or adverse change in liabilities due to a change in the expected exercise rates of policyholder options. The relevant options are all legal or contractual policy holder rights to fully or partly terminate, surrender, decrease, restrict or suspend insurance cover or permit the insurance policy to lapse.

The main elements of this risk for the Society are in relation to costs associated with running off the policies and sickness policy liabilities, with little impact on other policy liabilities.

Mortality Catastrophe risk

The Society holds £0.3m (2018: £1.8m) of capital against mortality catastrophe risk before taking risk diversification into account. This has reduced primarily due an increase in the level of catastrophe reinsurance cover for Group schemes.

Mortality catastrophe risk stems from extreme or irregular death events whose effects are not sufficiently captured in the other life underwriting risk sub-modules. Examples could be a pandemic event or a nuclear explosion.

The majority of the mortality catastrophe risk for the Society relates to Group business. The Society has mortality catastrophe and pandemic cover (£11.3m) via catastrophe reinsurance.

Mortality risk

The Society holds £1.7m (2018: £1.3m) of capital against mortality risk before taking risk diversification into account. The capital requirement has increased over the year following a renewal of one large Group scheme.

Mortality risk is the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of mortality rates, where an increase in the mortality rate leads to an increase in the value of insurance liabilities.

Mortality risk may occur in various ways, as a large scale event resulting in a significant increase in the number of deaths in a year (such as a major epidemic of influenza), or as a long-term trend of either increasing (for example due to a rise in obesity) or decreasing (for example as a result of better health education) mortality rates. Risks may also occur due to an inaccurate best estimate assumption or variation around the best estimate due to random fluctuations.

Diversification in the portfolio helps to mitigate mortality risk. The Society has a diversified population of members across its various funds with respect to age, gender, smoker status, level of life insurance cover, type of insurance cover and geographic location.

Although initial underwriting is limited (reflecting the Society's values in aiming to provide cover for the majority of applicants), this is taken into account in the product design and the level and types of covered offered.

Longevity risk

The Society holds £0.8m (2018: £0.8m) of capital against longevity risk before taking risk diversification into account and has remained constant over the year.

Longevity risk is the opposite of mortality risk, where a decrease in the mortality rate leads to an increase in the value of insurance liabilities.

Although the Society has a small annuity portfolio, the longevity capital requirement is mostly in respect of the costs associated with running off the closed with-profits funds and guaranteed annuity rates on pension policies.

Morbidity Catastrophe risk

The Society holds £0.7m (2018: £0.7m) of capital against morbidity catastrophe risk before taking risk diversification into account and has remained constant over the year.

Morbidity catastrophe risk results from the significant uncertainty of pricing and provisioning assumptions related to outbreaks of major epidemics, as well as the unusual accumulation of risks under such extreme circumstances. This risk is not material for the Society.

Non-Similar to Life Techniques Health risk

The Society holds £0.4m (2018: £0.4m) of capital against premium and reserve risk for the Guernsey medical expenses business before taking risk diversification into account.

C.2 Market risk

Market risk arises from the level or volatility of market prices of financial instruments.

Property risk

Property risk arises as a result of sensitivity to the level or volatility of market prices of the Society's direct property portfolio.

The Society holds £15.1m (2018: £16.7m) of capital against property risk before taking risk diversification into account; £0.3m (2018: nil) in the UK insurance funds, £0.6m (2018: £0.7m) in Guernsey and £14.2m (2018: £16.0m) in the UK Courts funds. Property risk in the UK insurance funds is due to investment in a new property fund during 2019. The Guernsey and UK Courts funds' property risk is due to directly held property holdings.

The Society's property holdings are all residential and commercial properties across the UK, valued at £59.3m (2018: £66.8m). The Society also holds £7.5m in property collectives (2018: nil).

Equity risk

The Society holds £9.8m (2018: £10.7m) of risk capital against equity risk before taking risk diversification into account; £1.6m (2018: £4.6m) in the UK insurance funds, £0.9m (2018: £0.6m) in Guernsey and £7.3m (2018: £5.5m) in the UK Courts funds.

Exposure to equity risk refers to all assets and liabilities whose value is sensitive to changes in equity prices. The Society's exposure to equities is in the form of collective equity holdings for all funds (2019: £32.8m) and convertible bonds (2019: £5.7m) compared to 2018 exposure of directly held stocks and shares (2018: £48.3m).

The Society owns a globally diversified equity portfolio that is representative for an average European insurance undertaking, i.e. it is not overweight in any high-risk sectors. The sensitivity of assets to changes in the volatility of the market parameters is not material, the Society does not hold any derivatives or hedge fund assets. However, the volatility of future investment returns does affect the Society's cost of guarantee provision. An increase of 5% in future volatility of asset returns increases the cost of guarantee provision by £1.2m (2018: 1.0m).

For the actively managed funds, the future risk profile could evolve as the components of the portfolio change over time. However, the restrictions within the investment mandates provided to the fund manager are designed to maintain the current risk profile in line with the fund objectives declared to policyholders.

Currency risk

Currency risk arises from changes in the level or volatility of currency exchange rates. The Society is exposed to currency risk arising from overseas equity holdings and investments in a fixed interest private debt fund denominated in Euros.

The Society holds capital of £1.7m (2018: £0.7m) against currency risk before taking risk diversification into account; £1.1m (2018: £0.7m) in the UK insurance funds and £0.6m (2018: nil) in the UK Courts funds. The increase over the year is largely due to investing in a globally diversified equity portfolio, following the change in investment manager.

The main sources of currency exposures within the equity funds are: US Dollars, Euros, Japanese Yen, Canadian Dollars, Danish Krone and Swiss Francs.

Currency exposure relating to the direct equity holdings in the POIS Flexible Growth Fund (within the Non-Profit Fund) is borne by policyholders.

There are no material foreign currency exposures in the fixed interest securities, property or other investments (including cash).

Interest rate risk

Interest rate risk exists for all assets and liabilities which are sensitive to changes in the term structure of interest rates or interest rate volatility, whether valued by mark-to-model or mark-to-market techniques. The risk to the Society is that assets and liabilities are not adequately matched and so do not move in line.

The Society holds £1.2m (2018: £0.5m) of risk capital against interest rate risk before taking risk diversification into account. An increase (2018: fall) in interest rates is the most onerous scenario for the Society. The capital requirement has increased over 2019 due an increase in fixed interest holdings.

The Society's portfolio of fixed interest holdings is diversified by term and coupon. Stress tests performed on the slope and shape of the yield curve in previous years did not result in significant additional capital requirements and although the range of holdings has been extended to include private debt this is expected to continue to be the case.

C.3 Credit risk

Credit risk means the risk of loss or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which the Society is exposed, in the form of counterparty default risk, spread risk or market risk concentrations.

Counterparty default risk

Counterparty risk reflects possible losses due to unexpected default of the counterparties and debtors of the Society over the forthcoming 12 months, including risk-mitigating contracts e.g. reinsurance arrangements, securitisations, derivatives and receivables from intermediaries.

The Society holds £1.8m (2018: £1.8m) of capital against the risk of counterparty default before taking risk diversification into account; £0.7m (2018: £0.6m) in the UK insurance funds and £1.1m (2018: £1.2m) in the UK Courts, via the Court Investment Fund portfolio.

Spread risk

Spread risk results from the sensitivity of the value of assets, liabilities and financial instruments to changes in the level or volatility of credit spreads over the risk-free interest rate term structure.

The Society holds £4.5m (2018: £2.9m) of capital against spread risk before taking risk diversification into account; £3.3m (2018: £2.9m) in the UK insurance funds and £1.2m (2018: £nil) in the UK Courts. The capital requirement has increased over 2019 due to an increase in fixed interest holdings, following the sale of property assets. This position is under review, whilst new investment opportunities are investigated.

Credit spread is the additional return earned over the risk-free rate. It reflects the riskiness of the assets and compensates the investor for the possibility of default. Any financial instruments which provide a fixed income stream will be sensitive to the risk of the credit spread increasing.

The classes of bond held by the Society to which this applies are:

- corporate bonds;
- fixed interest private debt issued to European SMEs; and
- loans other than retail loans secured by a residential mortgage.

UK Government bonds are exempt from spread risk capital under Solvency II regulations, so no spread risk capital is held. The Society does not hold any securitisations.

The Society's holdings of corporate bonds are predominantly within the with-profits funds and invested as part of with-profits investment strategies.

Concentration risk

This risk is not material for the Society and a trivial amount of capital is held (2019: £0.0m, 2018: £0.0m).

Concentration risk in respect of financial investments is restricted to the risk regarding the accumulation of exposures with the same counterparty. It does not include other types of concentrations (e.g. geographical area, industry sector, etc.). Exposures via investment funds need to be considered on a look-through basis.

Properties are excluded as none of the individual holdings are worth more than 10% of total assets. Gilts (fixed and index-linked) are also excluded as the risk factor for exposures to governments and central banks is 0%.

Analysis of the Society's direct equity and corporate bond holdings on a look-through basis shows small concentrations in respect of a handful of counterparties.

Any concentrations of more than 1.5% of the total assets considered for each ring-fenced fund results in a capital requirement, although in some cases the monetary amount of the holding may be relatively small.

C.4 Liquidity risk

This risk is not material for the Society and no capital is held.

Liquidity risk is that of not having sufficient liquid resources to meet changing market conditions and being unable to meet obligations as they fall due or being able to secure them only at excessive cost.

Liquidity is required to honour all cash flow commitments, both on and off-balance sheet, and these are generally met through cash flows supplemented by assets readily convertible to cash.

The management of liquidity should be consistent with the economic capital, regulatory and operational needs across the Society. The Board is responsible for defining the risk appetite and monitoring liquidity risk exposure.

In accordance with Article 260(2) of the Solvency II Delegated Acts, the Expected Profit Included in Future Premiums (EPIFP) has been calculated as £3.4m (2018: £2.9m). This is the expected present value of future cash flows which result from the inclusion in the technical provisions of premiums relating to existing insurance contracts that are expected to be received in the future, but that may not be received for any reason, other than because the insured event has occurred.

C.5 Operational risk

Operational risk is the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events. The Society accepts that operational risks will occur in the normal course of business and manages these risks within its framework.

The Society uses the standard formula approach for calculating its exposure to operational risk for Pillar 1 reporting.

The Society holds £1.3m (2018: £1.2m) of capital against operational risk before taking risk diversification into account, £1.2m (2018: £1.1m) in the UK insurance funds and 0.1m (2018: £0.1m) in the Guernsey Court.

The most material operational risks that the Society is exposed to are:

- Cyber Security threats, data security risks and internal or external financial crime impacting on members and reputation.
- IT system instability, leading to system outages, system interruptions, resulting in not being able to meet customer demand or expectations.
- Business disaster from external threats resulting in the inability to continue critical functions and business processes after the occurrence of a disaster, impacting on members of the Society.

- Risk of regulatory breaches either current regulation or regulatory developments not executed adequately.
- Conduct risk of not treating members fairly for new business or legacy books containing multiple issues by ineffective controls being in place.
- Process failures from administrative errors.

All operational risks are assessed through the Society's Risk and Control assessment process, review of internal operational risk event data, Key Risk Indicator trends and expert judgement. Risks are assessed from a financial and non-financial impact and follow the Society's categorisation model to ensure risks are assessed in line with the risk management framework. The Internal Audit function review operational related risks as part of the annual audit plan and report key findings to the ARCC. Audit findings are used to assess the control effectiveness and design held within the Society's Risk and Control assessments.

The Society monitors its operational losses through its loss reporting and assessment of the control environment, governance structures are in place to manage the Society within its operational risk appetite.

Scenario based risk assessments are used in the Society's ORSA, with plausible but extreme adverse scenarios being constructed to assess the likelihood and impact of the extreme event. The Society currently has 15 operational risk scenarios. A simple statistical method is used to fit a Log-Normal distribution to this data to determine capital requirements for these risks at a 99.5% confidence level.

For further information on the Society's risk framework see section B3.

C.6 Other material risks

In addition to the risks identified above, the Society is also exposed to a number of other risks for which it does not hold capital as it is not the most appropriate mitigant. The most material of these risks are: business risk, strategic risk, and reputational risk. These risks are detailed below.

Business Risk

Business Risk is the risk arising from changes to the business, including the inability to carry out the Business Plan and desired strategy. This is considered as part of the business planning and reverse stress testing processes.

The Society does not hold capital in respect of new business risks, as the potential impact on capital resources in excess of capital requirements has not been considered significant. As part of the Society's ORSA process sensitivities and scenarios were assessed in terms of new business sales, increasing new business is key to the long-term viability of the Society.

For the 2020 Business plan, three sales sensitivities were modelled, these were: 20% more sales than plan, closure of individual business and closure of both Group and individual business. Monitoring of overall sales plans for both Individual and Group business is undertaken. Profitability of sales and capital implications of increased sales and specifically capital implications of Group schemes is monitored.

Strategic Risk

Strategic risk is the risk of not achieving the strategic plan as a result of internal or external factors that serve to undermine either the strategy itself or its execution. Strategic risk is a function of the incompatibility of two or more of the following components:

1) the Society's strategic goals;
2) the business strategies developed;
3) the resources deployed to achieve these goals; and
4) the quality of implementation and the situation of the markets the Society is operating in.

Strategic risks are identified by the Board in setting the Society's strategy, the business planning process and the ORSA process which will then form part of the Society's overall risk assessment. For each strategic risk the correlation between these risks and other material risks are considered. For each strategic risk, associated controls and actions are to be identified and monitored. Strategic risks are identified through the Society's Risk and Control Assessment process.

Any strategic risk that is outside of management tolerance will be escalated to the Board through the escalation process. If the risk is of a significant nature, the Board should be informed by the CRO or CEO as soon as appropriate to do so.

The current main strategic risk for the Society is the delivery of the agreed strategic options as an outcome of the Business planning process.

Reputational Risk

Reputational risk is the risk of loss resulting from damage to a firm's reputation, which may include lost revenue or increased operating, capital or regulatory costs, consequent to an adverse or potentially criminal event, even if the company is not found guilty. Reputational risk is a risk in its own right but may also arise as a consequence of the crystallisation of other risks.

Reputational risk is effectively managed through business controls, including but not restricted to appropriate recruitment and vetting procedures and a suitable business culture and ethos, supplemented by effective media relations and communications activity.

C.7 Any other information

There is no other material information to disclose regarding the risk profile of the Society.

D. Valuation for Solvency Purposes

The Solvency II Directive includes standards for the valuation of the three main elements of the Solvency II Balance Sheet: assets, technical provisions and other liabilities. The balance sheet is prepared on a market-consistent basis, whereby assets are accounted for at market value and liabilities are assessed on an economic value basis.

The following table shows a high-level summary, with further details in the sections that follow:

£000s	2019	2018
Total Assets	282,689	267,549
Total technical provisions	(149,905)	(137,698)
Total other liabilities	(6,938)	(5,147)
Excess of assets over liabilities	**125,847**	**124,704**

2018 results have been restated to reflect a change in timing of premium recognition.

D.1 Assets

All material asset classes have been valued in accordance with the Solvency II regulations and are therefore recognised at economic value. The asset values for current and prior year are shown below:

£'000	2019		Restated 2018	
	Solvency II	UK GAAP	Solvency II	UK GAAP
Goodwill	-	-	-	-
Pension benefit surplus	335	426	220	362
Property, plant & equipment held for own use	1,665	61	101	51
Investments (other than assets held for index-linked and unit-linked contracts)	**229,535**	**229,215**	**223,399**	**220,788**
Property (other than for own use)	58,071	59,675	67,231	67,281
Holdings in related undertakings, including participations	10	-	-	-
Equities	**-**	**34,930**	**42,162**	**46,988**
Equities – listed	-	*34,930*	*42,162*	*46,988*
Equities - unlisted	-	-	-	-
Bonds	**40,296**	**128,231**	**102,253**	**100,939**
Government Bonds	*40,096*	*39,913*	*51,330*	*51,063*
Corporate Bonds	-	*88,318*	*50,723*	*49,876*
Structured Notes	*200*	-	*200*	-
Collective Investments Undertakings	129,616	6,378	11,396	5,580
Derivatives	-	-	-	-
Deposits other than cash equivalents	1,541	-	356	-
Other investments	-	-	-	-
Assets held for index-linked and unit-linked contracts	**35,408**	**35,722**	**31,292**	**31,079**
Loans and mortgages	**73**	**73**	**111**	**111**
Loans on policies	50	50	57	57
Loans and mortgages to individuals	23	23	53	53
Other loans and mortgages	-	-	-	-
Reinsurance recoverables	(82)	(82)	40	40
Insurance and intermediaries receivables	2,011	1,647	1,614	1,614
Receivables (trade not insurance)	1,807	2,272	1,550	3,100
Cash and cash equivalents	11,941	13,681	9,222	10,765
Any other assets, not elsewhere shown	(3)	-	-	-
Total assets	**282,689**	**283,016**	**267,549**	**267,911**

The change in investment managers over 2019 has resulted in a significant amount of investments held via collective funds, rather than the underlying assets directly held by the Society. This explains the large increase in collective investments over the year.

The table below provides a reconciliation between the UK GAAP and Solvency II value of assets at the valuation date. Other in-line differences in the balance sheets are presentational.

£'000	2019	Comments
UK GAAP value of assets	**283,016**	
Prepayments	(235)	See explanation below: "Receivables (trade not insurance)".
Pension scheme valuation	(91)	See explanation below: "Pension benefit surplus".
Solvency II value of assets	**282,689**	

Property

Property, including land and buildings held by the Society for operational purposes, covers freehold and leasehold investment properties held for long-term rental yields and capital growth.

Properties other than those held by the Society for operational purposes are valued at least annually on an open market value basis by qualified external professional valuers. Properties held for operational purposes are valued at least annually on an existing use value basis by qualified external professional valuers.

Property asset values have been determined by reference to present and future income flows based on current day values supported by market evidence. In addition, lease terms, floor areas and enquiries within the marketplace have also been factored in.

Properties occupied by the Society are required to be depreciated over their expected useful economic lives under the requirements of the Friendly Societies Act 1992. In respect of investment properties, this requirement conflicts with the generally accepted accounting principle set out in section 16 of FRS 102 for Investment Properties, that no depreciation should be provided on such investments. The Board consider that, as these properties are held for investment, to depreciate them would not give a true and fair view, and that it is necessary to adopt FRS 102 in order to give a true and fair view. Depreciation is only one of the factors reflected in the annual valuations, and the amount which might otherwise have been shown cannot reasonably be separately identified or quantified.

Freehold land is not subject to depreciation. No depreciation is charged on freehold buildings as, in the Directors' opinion, it is considered that their estimated useful economic lives and residual values are such that the required depreciation charge is immaterial.

Financial Investments

Other financial investments comprise listed investments, units in authorised unit trusts, loans, mortgages, deposits with credit institutions and deposits with Investment Associations.

Listed investments and units held in authorised unit trusts are measured at their bid value at the balance sheet date, based on observable market prices.

Amounts receivable in respect of loans and mortgages are shown at the lower of the amounts advanced or the amount expected to be recovered where there is evidence of impairment.

Deposits with credit institutions are carried at their historical cost as the economic value equals the fair value since these items are effectively cash deposits.

Deposits with the Derby Investment Associations are shown at cost plus interest accrued on the deposit which is the value at which the deposits could be withdrawn and is therefore considered to be a material approximation of the economic value under Solvency II.

The Society does not currently invest directly in derivative contracts.

Investments in subsidiaries and associates are measured at cost less impairment, which is a material approximation to the adjusted equity method required under Solvency II in view of the immaterial balance involved.

Unit-linked business

Assets held in respect of unit-linked business are fair valued at bid price using market prices supplied by third party data providers.

Property, plant and equipment

Impairment reviews were carried out as part of the assessment of the net book value recognised in the UK GAAP value in the financial statements and, as there was no need for impairment identified, the carrying value from the financial statements is considered to be a material approximation of their economic value under SII.

Cash

Cash and cash equivalents are held at fair value.

Insurance receivables

Insurance receivables are outstanding premiums. These are held at fair value which may include a provision for impairment where they are past their due date.

Receivables (trade not insurance)

Prepayments to the value of £235k (2018: £220k) shown in the financial statements have been removed from the Solvency II balance sheet as they relate mainly to software licences which are not considered to have any economic value.

Accrued interest has been reclassified and is shown in the Solvency II balance sheet in the economic value of the asset to which it relates.

Pension benefit surplus

The Society operates two defined benefit pension schemes for which the asset or liability recognised in the balance sheet is the present value of the defined benefit obligation at the reporting date less the fair value of the plan assets at the reporting date.

The actuarial valuations of both schemes have been updated to the accounting date by an independent qualified actuary. The schemes have been valued using the IAS 19 / IFRIC 14 basis as permitted under Solvency II rules. This is a different treatment compared to the value attributed to pension schemes in the Society's Reports and Accounts, but the difference in value is not material at £91k (2018: £142k).

Valuation in financial statements

There are no other material differences between the bases, methods and main assumptions used by the Society in the asset valuation for solvency purposes and those used for its asset valuation in financial statements.

D.2 Technical provisions

The value of technical provisions is equal to the sum of a best estimate liability ('BEL') and a risk margin ('RM').

The BEL takes account of all the cash inflows and outflows required to settle the Society's insurance contracts. It is the present value of the expected benefit payments and expenses less the expected premium income.

The RM assumes that the Society's insurance contracts are transferred to another insurer, and takes into account the cost of holding regulatory capital for that insurer until the contracts are settled. Only risks that are not easily hedged are included in the risk margin.

The BEL is calculated gross of any outward reinsurance and a separate reinsurance recoverable asset is included in the balance sheet.

The Society's technical provisions at 31 December 2019 is provided below, with a comparison to the prior year.

£'000	2019			2018		
	Best Estimate	Risk Margin	Total	Best Estimate	Risk Margin	Total
Health (similar to non-life)	*154*	*29*	**183**	*262*	*28*	**290**
Health (similar to life)	*1,708*	*1,044*	**2,752**	*1,754*	*814*	**2,568**
Life (excluding health and index-linked and unit-linked)	*111,367*	*2,755*	**114,122**	*103,381*	*2,494*	**105,875**
Index-linked and unit-linked	*32,695*	*153*	**32,848**	*28,821*	*144*	**28,964**
Total technical provisions	***145,924***	***3,981***	**149,905**	***134,218***	***3,480***	**137,698**

2018 results have been restated to reflect a change in timing of premium recognition.

With-Profits Funds

The best estimate liabilities (BEL) consist of asset shares plus the cost of guarantees less the present value of future charges, net of future expenses, on accumulating with-profits business only, in the OIF, PEF, Tunstall, and POIS Funds.

For the Leek Fund, because the guarantees are so far 'in-the-money', a gross premium reserve is calculated, effectively treating the policies as if they were non-profit policies. The gross premium reserve is calculated as the benefits expected to be paid, plus the expenses expected to be incurred, less expected gross premiums to be received.

A stochastic model is used to calculate the cost of guarantees for all with-profits business. The model projects a large number of future economic scenarios and investment returns, to determine the expected cost of the guarantees provided by the Society. The economic scenarios and the distribution of returns is based on observed market data, where available, and assumptions regarding the volatility of property, corporate bonds and convertible bonds assets, and the correlation of returns between the asset classes modelled.

Projected cash flows underlying the best estimate liability cease at the contract boundary for a given contract type. The boundary of the contract is determined by the future date where the Society has a unilateral right to either:

- reject premiums payable under the contract;
- terminate the contract; or
- amend premiums or benefits payable under the contract in such a way that the premiums fully reflect the risks.

The main impact on the Society is for with-profits recurrent single premium policies: any expected future premiums beyond the balance sheet date are ignored as these are not obliged to be paid by the policyholder. As a result, few premiums may have been received and a potentially substantial expense provision may be required. This affects the provisions for regular premium Individual Savings Accounts (‘ISA’) and Child Trust Funds (‘CTF’).

Non-Profit business

The best estimate liabilities are calculated as a gross premium reserve, as described for the Leek Fund above.

For the purpose of calculating the value of future sickness claims, the inception-annuity methodology has been employed throughout the valuation. The inception-annuity method considers the following two functions:

- the inception rate: This is the probability that a currently healthy life becomes disabled and remains disabled until the end of the deferred period; and
- the termination annuity: This is the present value at the date of disablement of expected claim payments until the claim ceases, either due to recovery, death or reaching the end of the maximum benefit period. The calculation allows for benefit escalation, interest and terminations (via death and recovery) from the end of the deferred period.

At any point in time the value of expected claims for a particular policy under the inception-annuity approach can be expressed as the sum across all future time periods of the inception rate multiplied by the disabled life annuity.

The Society’s long-term sickness policies typically include a waiver of premium benefit while policies are in claim. This is included in the benefit amount used to calculate the best estimate liabilities.

A provision for claims currently in payment is calculated as the present value of all future payments that are expected to be made to these claimants. The same term structure of interest rates is used to discount these claim payments as used in the gross premium reserves. This provision forms part of the policy liabilities rather than being shown separately.

No provision for incurred but not reported (“IBNR”) claims is established as the majority of the Society’s business is written with short deferred periods. Reviews of claims on short-term sickness policies have not shown any evidence of delays in reporting.

Unit-linked business

Unit reserves are set in line with linked liabilities and non-linked reserves are derived using charges less expenses for unit-linked business. There is also a small reserve for the cost of guarantees related to some unit-linked business. Unit-linked liabilities consist of the unit reserve (value of units attached to policies), the non-unit reserve and a reserve for the cost of guarantees.

Unit liability

The unit liability is equal to the value of units allocated to policyholders. The total balance sheet value of the unit funds may be slightly different to this due to the operation of the "Box". The Box effectively acts as a buffer and reduces the expense of making a series of small transactions.

Non-unit liability

The following approach has been adopted in determining the non-linked reserves for unit-linked policies:

- compare the future charges with the future directly attributable expenses on a policy by policy basis allowing for the cost of life cover; and
- if future charges are more than sufficient to meet future directly attributable expenses then credit can be taken for the excess, and a negative non-linked reserve held.

Group business

The BEL in respect of Group business has been estimated using a cash flow model allowing for future premiums, claims allowing for delays in claim notification, expenses and the cost of claims in payment. Group business has a contract boundary at the premium review date.

Guernsey Medical Expenses Business (MEB)

The BEL has been calculated for the Guernsey MEB using a cash flow model with a one-year contract boundary. The cash flow model allows for premiums, claims allowing for delays in claim notification and renewal expenses. The one-year contract boundary is appropriate as these are annual policies which are all renewable on 1 January each year.

Additional expense liabilities

Although the basic liabilities include an explicit allowance for future expenses, there will still be an additional expense provision:

- for expenses above the maximum amount allowed to be charged to a ring-fenced with-profits fund either by virtue of an Instrument of Transfer or Board agreement;
- where asset share expenses do not equal capped expenses (this can be positive or negative); and
- for overhead expenses not attributed to policies.

The different types of expenses are explained in more detail in the assumptions section below.

Risk margin

The risk margin is calculated as a 6% per annum cost-of-capital charge on the non-market risk components of the SCR in each future year. The non-market risk components are the insurance, counterparty and operational risk components of the SCR. The 6% rate is laid down in the Solvency II regulations.

The Society has used a simplified method for calculation of the risk margin where it has been calculated on the basis of estimating all future SCRs 'at once' (the duration approach), as set out in EIOPA's Guidelines on the valuation of technical provisions (Guideline 62, Method 3 and Technical Annex IV).

The calculation has been carried out for each fund and the total risk margin has been calculated as the sum of the risk margins for each fund. For non-profit funds, the risk margin is split into lines of business (unit-linked, health and other) in proportion to liabilities or by risk capital components as appropriate.

In order to use this approximation, the following assumptions used in the methodology have been considered:

- for the basic SCR, the composition and the proportions of the risks and sub-risks do not change over the years;
- for counterparty default risk, the average credit standing of reinsurers and Special Purpose Vehicles ('SPV') remains the same over the years;
- for operational risk and counterparty default risk, the modified duration is the same for obligations net and gross of reinsurance;
- market risk in relation to the net best estimate remains the same over the years; and
- the loss absorbing capacity of the technical provisions in relation to the net best estimate remains the same over the years.

Based on the work done during the Solvency II preparatory phase, the Society believes that it satisfies these requirements. However, this will be kept under review in future years.

Provisions other than technical provisions

These are provisions for outstanding claims, all of which are past due and therefore held at economic value.

Main assumptions

The assumptions used for calculating the BEL are realistic with no margin for prudence. The economic assumptions are based on market data.

The approach to setting non-economic assumptions is based on the Society's experience which is reviewed annually.

The mortality assumptions use standard CMI mortality tables, adjusted to reflect the Society's own experience where appropriate. The assumptions also allow for mortality improvement for with-profits business.

The sickness inception and recovery rates used in the valuation are based on industry standard tables of inception and recovery rates, adjusted for the actual experience of the Society. Termination rates allow for both recoveries, policyholders claiming who become well again and are eligible to claim again in the future, and deaths of policyholders who were claiming. Mortality rates for those policyholders claiming have been assumed to be the same as for those not claiming.

On expense assumptions, the Solvency II Directive requires that the Society takes into account all future expenses that relate to existing in-force business assuming that the Society continues to write new business in calculating the technical provisions. Solvency II Level 3 Guidance (Guideline 29) says that firms should consider expenses by homogeneous risk groups and as a minimum by line of business. Given the Society's size and structure it is deemed more appropriate to consider expenses by long-term business fund rather than by line of business.

The expense assumptions are derived by dividing the expected maintenance expenses over the coming year by the average number of policies in-force during the current year. Where the expenses charged to a fund are capped, either by virtue of an Instrument of Transfer or Board agreement, only the expense up to the capped level is provided for in each fund, with the excess being held in the Non-Profit Fund.

The Society's approach to setting the best estimate basis for lapse and paid-ups is to generally use the same shape as the previous best estimate basis but to revise if there is strong evidence that the shape no longer represents the actual lapse experience and to set the basis based on observed experience rounded to the nearest 0.25% unless the change would be immaterial.

Asset shares for the OIF, Tunstall and POIS funds are rolled forward from the previous year end at the gross return achieved on the backing assets. As the PEF, Tunstall and POIS funds (which are all closed to new business) are managed without an estate, the investment return applied to the asset share in these funds is adjusted so that there is no surplus in the fund.

Future investment returns are set at a level derived from the British Pound (GBP) risk-free spot rates. The risk-free yield curve for 31 December 2019 was published by EIOPA in the first week of January 2020 on their website (https://eiopa.europa.eu/regulation-supervision/insurance/solvency-ii-technical-information/risk-free-interest-rate-term-structures).

Uncertainty

In calculating the technical provisions, assumptions have been made about future experience on a best estimate basis in accordance with Solvency II regulations. Due to the uncertain nature of the business these assumptions are not likely to be borne out exactly in line with expectations and any deviation will emerge as an experience variance over time.

Valuation in financial statements

There are no material differences between the bases, methods and main assumptions used in the valuation for solvency purposes of the UK insurance business liabilities and those used for the Society's financial statements.

The treatment of the Guernsey medical expenses business differs in that the accounts show a general insurance business provision as a balancing item of surplus assets, whereas Solvency II technical provisions have been calculated as a best estimate liability plus risk margin for solvency purposes.

The general insurance business provision plus outstanding claim reserve at year-end 2019 is £4.30m (2018: £4.01m) compared to a Solvency II technical provision of £0.18m (2018: £0.29m).

The pension benefit surplus has been revalued using the IAS 19 / IFRIC 14 basis as permitted under Solvency II rules. This is a different treatment compared to the value attributed to pension schemes in the Society's Reports and Accounts, with an immaterial resulting difference in value. The value under IAS 19 / IFRIC 14 is £0.34m compared to £0.43m in the Reports and Accounts.

Transitional measures and adjustments

The Society has not made use of any of the following transitional measures or adjustments referred to in EU Directive 2009/138/EC:

- (i) the matching adjustment (Article 77b)
- (ii) the volatility adjustment (Article 77d)
- (iii) the transitional measure on equity risk sub-module (Article 308b)
- (iv) the transitional measure on risk-free interest rates (Article 308c)
- (v) the transitional deduction on technical provisions (Article 308d).

Reinsurance contracts

There is some exposure to the risk of reinsurer default.

There are two main areas of risk within the Society's business which are currently reinsured. Credit has been taken for these arrangements in calculating the SCR and therefore allowance has also been made for the risk of reinsurer default.

Group Schemes

Life catastrophe excess of loss cover is in place for the Group schemes, at a level of £11.3m (2018: £9m) in excess of £0.5m (2018: £0.5m). The risk is split between HCC International Insurance Company, TransRe London, TransRe Zurich and Third Point Reinsurance.

POIS Ring Fenced Fund

Two treaties exist with Swiss Re for business written within the POIS Fund. These were both closed to new business in 2002. The net reinsurance recoverable is £228k (2018: £205k).

The small element of counterparty default risk from the reinsurance is fully absorbed by the surplus within the fund.

Special purpose vehicles

The Society does not use any SPVs.

Changes to methodology and assumptions over the reporting period

The key updates to methodology and assumptions used for calculating the technical provisions since the previous technical provisions calculation at 31 December 2018 are:

- economic assumptions have been updated to 31 December 2019; and
- expense assumptions have been updated, reflecting improvements in the expense assumption setting process.

D.3 Other liabilities

Other liabilities of the Society at 31 December 2019, with comparatives at 31 December 2018, were as follows:

£'000	2019		2018	
	Solvency II	UK GAAP	Solvency II	UK GAAP
Other technical provisions	-	3,611	-	2,588
Provisions other than technical provisions	3,260	-	2,392	-
Pension benefit obligations	-	-	-	-
Payables (trade not insurance)	3,678	3,662	2,755	2,711
Total other liabilities	**6,938**	**7,273**	**5,147**	**5,299**

Other technical provisions in the financial statements consist of outstanding claims, which have been:

- re-classified as provisions other than technical provisions for the UK Life insurance funds; and
- form part of the technical provisions for the Guernsey fund.

Other liabilities include payments due to HMRC in respect of PAYE and VAT, unclaimed balances from pre-incorporation and invoices awaiting payment, which may contain some immaterial amounts not yet due for payment which have not been adjusted for on the grounds of proportionality.

Other than the treatment of the Guernsey medical expenses business explained in D.2 there are no material differences between the bases, methods and main assumptions used by the Society for the valuation of other liabilities for solvency purposes and those used for their valuation in financial statements.

D.4 Alternative methods for valuation

There were no alternative methods required for the valuation of the Society’s assets or liabilities.

D.5 Any other information

There is no other material information to be disclosed regarding the valuation of the Society’s assets and liabilities for solvency purposes.

E. Capital Management

E.1 Own Funds

The Society has a Capital Management Policy and a Medium-Term Capital Management Plan which outlines the overall aim and approach to be taken for capital management, together with the standards and parameters which must be adhered to and reporting requirements and responsibilities.

The objective is to ensure that the Society has sufficient capital resources to remain solvent on both a regulatory basis (Solvency II Pillar I) and an economic basis (Solvency II Pillar II).

The capital projections shown in the ORSA over the 5-year business planning period facilitate Board discussion on the capital requirements of each fund and the Society as a whole. Separate consideration is given to the in-force portfolio and the impact of writing new business.

As part of the ORSA, the Society reviewed its target capital risk appetite thresholds, measured in terms of capital coverage ratio (Own Funds as a percentage of SCR). The table below sets out the Red/Amber/Green levels agreed by the Board.

Fund	Green	Amber	Red
OIF	> 150%	150% - 120%	< 120%
NPF	> 160%	160% - 120%	< 120%
UK Insurance Operations	> 140%	140% - 115%	< 115%
Society	> 115%	115% - 105%	< 105%

Some of the Society's own funds are restricted by the ring-fenced adjustments described below to give eligible Own Funds. All the Society's eligible Own Funds are classified as Tier 1 high quality unrestricted capital, i.e. assets which are free from any foreseeable liabilities and are available to absorb losses due to adverse business fluctuations on a going-concern basis and in the case of winding-up. This has been the position over the whole of 2019.

As the Society's eligible Own Funds are all Tier 1, they are available in full to cover the SCR and MCR.

Ring-Fenced Fund Adjustments

Under Solvency II the with-profits funds are classified as ring-fenced funds ('RFF'), which means that the assets within these funds are for the benefit of those policyholders and cannot be used to support other areas of the business except in extremis. Hence any excess of assets over liabilities in the OIF, PEF, Tunstall, Leek and POIS funds cannot normally be used to support other areas of the business. If any of these funds have a deficit of assets over liabilities, then additional capital support can be provided from the non-profit funds.

Similarly, the assets of the Guernsey Court and UK Mainland Courts are ring-fenced for the benefit of the members of these courts and therefore cannot be used to support other areas of the business. This means these funds also meet the Solvency II definition of ring-fenced funds.

As the assets in these funds are not normally available to support other areas of the business the surplus assets are only available to cover the risks within these funds. This means the eligible Own Funds from these funds are restricted to the notional SCR for these funds. The restrictions as at 31 December 2019 are as follows:

2019 (£'000)	Excess of Assets over Liabilities	Notional SCR	Excess assets less SCR	Restricted Own Funds
OIF	6,612	2,987	3,625	3,625
PEF	-	7	(7)	-
Tunstall Fund	-	311	(311)	-
Leek Fund	(54)	25	(79)	-
POIS	(1)	72	(73)	-
Guernsey Court	4,937	1,712	3,225	3,225
UK Mainland Court	98,581	21,541	77,040	77,040
Total				**83,891**

The Leek fund has an excess of liabilities over assets which is supported by the Non-Profit Fund. In the PEF, Tunstall and POIS funds, any surplus arising is fully distributed to policyholders' asset share through adjustments to the discretionary benefits before the allocation of operational risk at a fund level. The allocation of operational risk in these funds has given rise to the negative excess assets shown in the table above.

The equivalent position as at 31 December 2018 is shown below:

2018 (£'000)	Excess of Assets over Liabilities	Notional SCR	Excess assets less SCR	Restricted Own Funds
OIF	7,376	5,760	1,616	1,616
PEF	-	9	(9)	-
Tunstall Fund	-	373	(373)	-
Leek Fund	(55)	20	(75)	-
POIS	-	81	(81)	-
Guernsey Court	4,403	1,469	2,934	2,934
UK Mainland Court	95,950	20,824	75,126	75,126
Total				**79,676**

Movements in Own Funds

The figures below show a fall in eligible Own Funds of £2.6m over 2019, from £44.6m to £42.0m. This is due to a number of offsetting factors, listed below:

- £1.5m increase from Group business, primarily due to renewals in the year;
- £1.0m increase from strong investment performance;
- £1.0m increase in Courts SCR, increasing the amount of eligible Own Funds recognised in respect of the Courts;
- £0.6m expected profit from the run-off of the risk margin;
- £0.6m increase from changes in valuation assumptions and methodology; offset by
- £2.9m reduction from adverse variances within the year, primarily driven by project costs that are not reserved for;
- £2.8m reduction in OIF SCR; decreasing the amount of eligible Own Funds recognised in respect of this fund;
- £1.5m strain from writing new individual business; and
- a number of other smaller items.

Eligible Own Funds (£'000)	2019	2018
Surplus Assets	**6,612**	**7,376**
Reconciliation Reserve:		
Excess of assets over liabilities – UK insurance funds	*22,329*	*23,951*
Excess of assets over liabilities – Guernsey	*4,937*	*4,404*
Excess of assets over liabilities – UK Courts	*98,581*	*95,950*
Own shares (held directly and indirectly)	-	-
Foreseeable dividends, distributions and charges	-	-
Other basic own fund items	*(6,612)*	*(7,376)*
Adjustment for restricted own fund items in respect of matching adjustment portfolios and ring-fenced funds	*(83,891)*	*(79,676)*
Total Reconciliation Reserve	**35,344**	**37,252**
Other Own funds that do not meet the criteria to be classified as Solvency II Own Funds	-	-
Eligible Own Funds	**41,956**	**44,628**

Equity amount shown in financial statements

As a mutual insurer, the Society does not have any equity shown in its financial statements for comparison with the excess of assets over liabilities as calculated for solvency purposes.

Transitional arrangements

The Society does not have any basic own fund items subject to the transitional arrangements referred to in Articles 308b(9) and 308b(10) of Directive 2009/138/EC (for businesses that ceased to write new insurance contracts prior to 1 January 2016).

Ancillary Own Funds

Ancillary own funds consist of items other than basic own funds which can be called up to absorb losses and may comprise the following items:

(a) unpaid share capital or initial fund that has not been called up,
(b) letters of credit and guarantees,
(c) any other legally binding commitments received.

The Society does not have any items of ancillary own funds and has not sought approval from the PRA to recognise any ancillary own funds.

Items deducted from Own Funds

The Society does not have any items deducted from own funds for participations in financial and credit institutions.

E.2 Solvency Capital Requirement and Minimum Capital Requirement

The amounts of the Society's Solvency Capital Requirement ('SCR') and Minimum Capital Requirement ('MCR') as calculated by the Society and submitted to the PRA are shown below at the reporting date and for the previous year, together with the level of capital coverage.

Note that the final amount of the SCR may change as a result of supervisory assessment.

SCR and MCR (£'000)	2019	2018	Movement
SCR – UK insurance funds	14,596	16,632	(2,036)
SCR - UK Courts	21,541	20,824	717
SCR - Guernsey	1,713	1,469	244
SCR	**37,849**	**38,925**	**(1,076)**
MCR	12,857	12,270	587
Total eligible Own Funds to meet the SCR	**41,957**	**44,628**	**(2,671)**
Total eligible Own Funds to meet the MCR	41,957	44,628	(2,671)
Ratio of Eligible Own Funds to SCR	**111%**	**115%**	**(4)%**
Ratio of Eligible Own Funds to MCR	326%	364%	**(38)%**

Movement in SCR over the reporting period

The overall SCR has reduced by £1.1m over the year due to a number of offsetting movements, these are discussed below.

A fall in the UK insurance funds SCR of £2.0m, from £16.6m to £14.6m, as a result of:

- Fall of £2.8m in SCR for the OIF, primarily caused by lower equity risk following capital optimisation work and lower equity holdings, partly offset by a rise in the equity stress from the symmetric adjustment falling.
- Increase of £0.8m in SCR for the Non-Profit Fund, primarily from:
  - lower catastrophe risk from an increase in the level of catastrophe reinsurance cover for Group schemes;
  - higher morbidity risk due to a renewal of one large Group scheme in 2019;
  - higher market risk due to a rise in the equity stress, caused by the symmetric adjustment falling; offset by
  - an increase in the diversification benefit between major risk types.

An increase in the UK Courts SCR of £0.7m, from £20.8m to £21.5m, primarily due to increased holdings in fixed interest investments with associated spread risk, in particular a private debt fund. Other changes in holdings had broadly offsetting impacts on the SCR.

An increase in the Guernsey SCR of £0.2m, from £1.5m to £1.7m, primarily due to an increase in equity risk following a fall in the symmetric adjustment and higher equity exposure.

Movement in MCR over the reporting period

The linear MCR is a function of:

- best estimate liabilities and capital at risk on protection business; and
- best estimate liabilities and written premium on general insurance business.

The MCR has increased by £0.6m over 2019, from £12.3m to £12.9m, driven by an increase in the linear MCR. The linear MCR has increased over 2019 due an increase in the lives covered by the Group business, increasing the capital at risk element of the MCR calculation.

The absolute floor of the MCR is set in Euros (Life €3.7m + General €2.5m) and has reduced slightly from £5.5m to £5.3m.

The table below sets out the high-level calculation of the MCR. Further detail can be found within the accompanying QRTs.

Minimum Capital Requirement (£'000)	2019	2018
Linear MCR	**12,857**	**12,270**
SCR	37,849	38,925
MCR cap	17,032	17,516
MCR floor	9,462	9,731
Combined MCR	**12,857**	**12,270**
Absolute floor of the MCR	5,340	5,510
MCR	**12,857**	**12,270**

SCR components by risk type

The SCR risk module components using the Standard Formula approach are set out in the table below. The SCR components shown within the table are gross of loss absorbing capacity of technical provisions, with the loss absorbency allowed for as an end-piece adjustment. This presentation is consistent with the QRTs that accompany this report.

SCR components by risk type	Gross SCR (£'000)	
	2019	2018
Market risk	39,071	37,663
Counterparty default risk	1,808	1,908
Life underwriting risk	8,478	7,579
Health underwriting risk	4,490	4,004
Non-life underwriting risk	-	-
Diversification	(9,788)	(9,013)
Intangible asset risk	-	-
Basic SCR	**44,060**	**42,142**
Adjustment due to ring-fenced fund aggregation	5,353	5,771
Operational risk	1,271	1,165
Loss-absorbing capacity of technical provisions	(12,835)	(10,153)
Loss-absorbing capacity of deferred taxes	-	-
Capital requirement for business operated in accordance with Art. 4 of Directive 2003/41/EC	-	-
SCR excluding capital add-on	**37,849**	**38,925**

Simplified calculations

The Society has not used any of the simplified calculations permitted within the risk modules and sub-modules of the Standard Formula, but has used a simplified method for calculation of the risk margin as described in section D.2.

Undertaking Specific Parameters

The Society has not used any Undertaking Specific Parameters ('USP') pursuant to Article 104(7) of Directive 2009/138/EC.

Non-disclosure

The PRA has opted to allow non-disclosure of any capital add-on or the impact of undertaking-specific parameters, as provided for in the third subparagraph of Article 51(2) of Directive 2009/138/EC for a transitional period ending no later than 31 October 2017.

The Society has not applied to the PRA for any such non-disclosure permission.

The Society has not been informed of any capital add-on to be applied to its SCR, nor has it been instructed to use any undertaking-specific parameters in accordance with Article 110 of Directive 2009/138/EC (where the Standard Formula is deemed not to be appropriate).

Minimum Capital Requirement

The inputs used to calculate the Society's MCR are as follows:

- medical expenses benefits;
- with-profits guaranteed benefits;
- with-profits discretionary benefits;
- unit-linked liabilities;
- other liabilities;
- capital at risk for all life obligations; and
- medical expenses written premiums.

The medical expenses written premiums are taken from the Society's income statement and, apart from the capital at risk, all the other above inputs are components of the BEL reported on the Solvency II balance sheet.

A linear MCR is calculated by applying given factors to each of the five inputs. The MCR is then restricted by a cap and a floor, being 45% and 25% of the SCR respectively, with an absolute floor of €5.2m (Euros).

The capital at risk is the difference between guaranteed benefits and the associated technical provisions and has two elements:

- death capital at risk; and
- disability capital at risk.

The capital at risk is associated with the Group business (2019: £14.9bn, 2018: £14.1bn) and is the major contributor to the Society's MCR.

E.3 Use of the duration-based equity risk sub-module in the calculation of the SCR

The Society has not taken up the option set out in Article 304 of Directive 2009/138/EC to use the duration-based equity risk sub-module for the calculation of its SCR.

E.4 Differences between the Standard Formula and any Internal Model used

The Society is not using an internal model to calculate its SCR, as it has demonstrated that the Standard Formula is appropriate given the nature, scale and complexity of the Society's insurance business.

E.5 Non-compliance with the MCR or SCR

The Society has complied with both its MCR and SCR throughout 2019 and remains compliant at the reporting date of 31 December 2019.

E.6 Any other information

There is no other material information to disclose regarding the capital management of the Society.

Appendix I. Table of Abbreviations

ARCC	Audit Risk and Compliance Committee
BEL	Best Estimate Liability
BRCC	Business Risk and Compliance Committee
CIF	Court Investment Fund
CIO	Chief Investment Officer
CCO	Chief Compliance Officer
CMI	Continuous Mortality Investigation
CRO	Chief Risk Officer
CTF	Child Trust Fund
EIOPA	European Insurance and Occupational Pensions Authority
EPIFP	Expected Profit Included in Future Premiums
FCA	Financial Conduct Authority
FRS	Financial Reporting Standards
IBNR	Incurred but not reported
IFA	Independent Financial Advisor
ISA	Individual Savings Account
JISA	Junior ISA
KRI	Key Risk Indicator
LF	Leek Fund
LISA	Lifetime ISA
MCR	Minimum Capital Requirement
NPF	Non-Profit Fund
OIF	Order Insurance Fund
ORSA	Own Risk and Solvency Assessment
PEF	Pure Endowment Fund
POIS	Post Office Insurance Society
PPFM	Principles and Practices of Financial Management
PPP	Prudent Person Principle
PRA	Prudential Regulation Authority
RFF	Ring Fenced Fund
RM	Risk Margin
SCR	Solvency Capital Requirement
SFCR	Solvency and Financial Condition Report
SM&CR	Senior Managers and Certification Regime
SPV	Special Purpose Vehicle
TESP	Tax Exempt Savings Plan
ULAA	Unit-Linked Advisory Arrangement
USP	Undertaking Specific Parameters
WPAA	With-Profits Advisory Arrangement

Appendix II: Extract of QRT forms

These are shown in the attached pdf "SFCR Disclosures".