Annual Report to With-Profits Policyholders for 2020

1 Summary

The Society has reviewed the management of its with-profits funds. The Society believes that it has complied with its obligations relating to its Principles and Practices of Financial Management.

The following sections provide the background and reasons for the Society having reached this opinion.

2 Introduction

The Principles and Practices of Financial Management (the PPFM) sets out the way that the Foresters Friendly Society (the Society) manages its with-profits business.

The Financial Conduct Authority rules require insurers to provide an annual report to with-profits policyholders on whether the Society believes it has complied with its obligations in relation to its PPFMs. In addition the report should describe how the Society has exercised discretion and the way that the Society has addressed matters such as the respective interests of its policyholders.

The Society maintains a number of with-profits funds (which may also include non-profit policies), namely the "Order Insurance Fund", the "Pure Endowment Fund", the "Tunstall Fund", the "Leek Fund" and the "POIS Fund". The Tunstall Fund, the Leek Fund and the POIS Fund were set up as a result of transfers of engagements to the Society on 31st December 2003, 31st December 2005 and 26th September 2014 of the Tunstall Assurance Friendly Society Limited, the Leek Assurance Collecting Society and the Post Office Insurance Society business from Family Assurance, respectively. Each with-profits fund is ring-fenced with each fund having its own separate portfolio of assets.

3 Governance Arrangements

The Board has responsibility for compliance with the Society's PPFMs. The Society has set up a With-Profits Advisory Arrangement (WPAA), which is made up of non-executive directors. Details of the members are shown in the Society's Annual Report and Accounts. The role of the WPAA is to exercise independent judgement in assessing compliance with the Society's PPFMs and in addressing conflicting rights and interests of policyholders within the with-profits funds. The Board and the WPAA are advised by the With-Profits Actuary.

The With-Profits Actuary provides advice to the Board on the exercise of discretion with regard to with-profits contracts, including on key aspects of the application of the Society's PPFMs. The With-Profits Actuary's report to policyholders in respect of 2020 is contained in the Appendix to this report.

4 Compliance with the obligations of the PPFM including the exercise of discretion

4.1 Investment Policy

Investment performance is considered at least quarterly by the Society's Investment Committee. The Society monitors the actual assets held against the target ranges in the PPFM on a monthly basis.

During 2020 asset classes were generally within the target ranges for the with-profits funds except for:

- In February 2020, the Order Insurance Fund was slightly below the target range for equities. This was a passive breach due to the large falls in equity markets due to the COVID-19 pandemic.
- Between March and November 2020, the Order Insurance and Tunstall Funds were outside the range of asset class allocations set out in the PPFM due to the derisking of these funds following extreme market volatility seen in Q1 2020 as a result of the COVID-19 pandemic. Disinvestments were made out of equity, convertible debt and ethical investment funds, with the proceeds invested into UK government bonds.
- In December 2020, the Order Insurance Fund allocations to conventional and index linked gilts were slightly below the minimum limits set out in the new strategic asset allocation agreed in the same month. *A new strategic asset allocation was approved in December 2020, with subsequent reinvestment into risk seeking asset classes.*

As part of the 2020 year-end valuation, and the final bonus review in 2021, segregation of the Order Insurance Fund investment portfolio (between Ethical and other with-profit policies) was not recognised and the same investment return was allocated to all policies in the fund. This ensured fairer treatment across all policies in the fund, whilst maintaining Ethical policyholders' expectations, and is a change in practice.

4.2 Bonus Rates

This is the main area of discretion in managing the Society's with-profits business. Section 2 of the POIS PPFM and sections B4, B5, C5 and C6 of the PPFM for the remaining funds describe how the Society exercises its discretion in setting bonus rates (section 2 of the PPFM effective from November 2020).

In February 2020, annual bonus rates were reviewed and the rates declared were lower than the previous year for the majority of products in the Order Insurance and Tunstall Funds. The reduction was largely driven by falls in long-term interest rates, as well as other factors.

Whilst the principles are being followed, the method used to set bonus rates for the Tunstall and POIS Funds have evolved from the practises discussed within the PPFMs. In particular, using an estimated future investment return that is higher than those implied by UK government bonds (gilt assets), as indicated in the PPFM. The estimated future investment return is based on advice received by the Society's external Investment Managers.

Revised final bonus rates for the with-profits funds were adopted with effect from 1 July 2020. In deciding on the revised bonus rates, the Board considered the advice of both the WPAA and the With-Profits Actuary.

The Society believes that the bonus rates were consistent with the PPFM.

A review of the Leek Fund was carried out which concluded that the fund continues to be unable to afford to pay bonuses.

4.3 Payouts

Maturity values are the amounts payable upon reaching the end of the term of the policy.

Surrender values, where applicable, are the amounts payable upon cancellation of a policy before it would otherwise be payable upon death or maturity. The calculation of surrender values was reviewed and updated as part of the review of final bonus rates.

For some products the Society has the right to apply a Market Value Reduction to reduce the amount paid on surrender to an amount that fairly reflects a policy's value. During 2020 the Society chose not to impose Market Value Reductions.

A review of the Society's with-profits funds' payout ratios during 2020 indicated that a number of instances have meant that fewer than 90% of the payouts were within the PPFM target range of 70% to 130% of the asset share. These instances relate to:

- maturity payouts for the POIS Fund;
- surrenders payouts for the Order Insurance, Tunstall, POIS and Pure Endowment Funds; and
- death payouts for the POIS Fund.

The Society investigated the reasons for this outcome.

For maturities:

- POIS Fund: 79% of payouts were within the target range and most outside the target range were paid more than asset share. Payouts outside the range were primarily related to payouts being higher than asset share, due to a single terminal bonus scale applied to both endowment and whole of life business. This is in line with the PPFM. The Society is currently implementing a change to the policy administration system to bring the payouts within range.

For surrenders:

- Order Insurance Fund: 89% of the payouts were within the target range, so just short of the expected level. The majority of surrenders outside the desired range were paid above 130% of asset shares. This is the consequence of smoothing payouts, where asset shares reduced due to adverse investment performance as a result of the impacts of the COVID-19 pandemic.

- Tunstall Fund: 53% of payouts were within the target range. Payouts outside the range were above 130% of asset share. This is the consequence of smoothing payouts, where asset shares reduced due to adverse investment performance as a result of the impacts of the COVID-19 pandemic. The application of smoothing is consistent with the PPFM.

- POIS Fund: 57% of payouts were within the target range. The fund is limited by one terminal bonus scale applied to both endowments and whole life business. This is in line with the PPFM. The Society is implementing a change to the policy administration system to bring the future payouts within range.

- Pure Endowment Fund: 40% of payouts were within the target range, corresponding to 3 claims. The claims outside the target range were a consequence of the surrender basis.

For deaths:

- POIS Fund: 33% of the payouts were within the target range. The majority of these deaths were paid below 70% of their asset share, when measured by number of policies. However. the majority were paid in excess of 130% of asset share when measured in monetary amounts. The deviation from the target range is due to the limitations of the single terminal bonus scale. As mentioned above, the Society is implementing a solution to resolve this for future payouts.

Despite not meeting all of the target range requirements, the Society is satisfied it has exercised discretion during 2020 in a manner that takes with-profits members' interests into account.

4.4 Management of the Inherited Estate

The Inherited Estate is defined in the Glossary of the POIS PPFM and paragraph 6.1 of the PPFM for the remaining funds as:

> "The excess of assets maintained within a with-profits fund over and above the amount required to meet liabilities (including liabilities which arise from the regulatory duty to treat customers fairly in setting discretionary benefits)"

For the Pure Endowment Fund, special bonuses were declared at incorporation to reflect the differing financial positions and past practices of the Districts, so as to ensure equitable treatment for the former members of each district.

For the Pure Endowment, Tunstall, Leek and POIS Funds, the method of determining policy payouts aims to ensure that any surplus is extinguished as the portfolio of business declines. The inherited estate for these funds can therefore be considered to be negligible.

For the Order Insurance Fund, being the with-profits fund open to new business, the inherited estate continues to provide working capital to support new business risks within the fund. Miscellaneous profits and losses are absorbed by the inherited estate, to be allocated to with-profits policies in the future, depending on the size of the estate and risk profile of the fund.

4.5 Charges

During 2020 the Board has continued to limit the effective charge to with-profits policies in the Order Insurance Fund and the Pure Endowment Fund to less than the actual expenses incurred, with the difference borne by the Society's Non-Profit Fund.

For the Tunstall Fund, the Leek Fund and the POIS Fund the charges for expenses have been in accordance with the transfer agreements, updated in accordance with those agreements, and in addition, the Society has agreed a subsidy to further limit the expenses charged to the Leek Fund.

4.6 New Business

The Pure Endowment Fund, the Tunstall Fund, the Leek Fund and the POIS Fund are all closed to new business. The Order Insurance Fund is the only with-profits fund that is open to new business. The profitability of the new business being written is considered on an annual basis.

As part of the annual planning process, the Board remain satisfied that it is in the interests of the with-profits policyholders for the Society to remain open to new business, with the Non-Profit Fund meeting expense overruns.

However, in March 2021, the Board considered the terms on which recent new TESP and CTESP with-profits business had been written and made a decision to enhance the terms of some policies, and to close the product to new business from 6 April 2021.

4.7 Managing Competing or Conflicting Rights of Policyholders

The Society is a mutual organisation and therefore avoids any competing or conflicting rights between policyholders and shareholders. However, different groups of policyholders have potentially competing interests due to:

- different types of products;
- policies of different sizes or policy terms;
- policies with different start and end dates; and
- different with-profits funds.

An important consideration in ensuring that the interests of different groups are balanced is the way that policies are grouped together. Policies are grouped together into distinct classes within each fund, taking the following criteria into account:

- taxable or tax-exempt policy status;
- endowment, whole life or pensions;
- regular or single premium paying status; and
- conventional or accumulating with-profits product type.

Different bonus rates are declared for distinct classes of with-profits business.

When setting bonus rates the Society aims to limit the size of the change in payouts on policies of a similar type to no more than 10% from year to year. However, as set out in paragraph 2.63 of the Foresters PPFM, the Society may impose larger changes on payouts. The extreme market volatility seen in Q1 of 2020 led to larger changes imposed on the Tunstall Fund.

The approach taken during 2020 was consistent with the PPFM.

4.8 Changes to the PPFM

An updated Foresters PPFM was approved by the Board in February 2020 with effective date November 2020. Details of the changes can be found on the Society's website: www.forestersfriendlysociety.co.uk/about-us/reports-governance.

The Society's PPFMs provide definitions of the terms used within this paper. The PPFMs are available on our website. If you would like a copy of the PPFM, please contact our Member Services team on 0800 988 2418 during our normal office hours.

Appendix: Report of the With-Profits Actuary to With-Profits policyholders of The Ancient Order of Foresters Friendly Society Limited

I have been appointed by The Ancient Order of Foresters Friendly Society (the Society) to act as the With-Profits Actuary (WPA). I was formally appointed to this role in April 2020. The previous WPA was Kim Durniat of Barnett Waddingham Limited. I am a Fellow of the Institute and Faculty of Actuaries and I am not a policyholder of the Society.

The Society must produce an annual report to its with-profits policyholders that states whether it believes it has complied with its obligations relating to the Principles and Practices of Financial Management (PPFM) and setting outs its reasons for that belief.

I am also required by the FCA Handbook to provide a report to with-profits policyholders to accompany the firm's annual report, stating whether, in my opinion, the discretion exercised by the firm in respect of the period covered by the report may be regarded as taking the interests of the firm's with profit policyholders into account in a reasonable and proportionate manner. In doing this, I must have regard to the rules and guidance laid down in the FCA Handbook.

The purpose of this report is to comment to with-profits policyholders on the exercise of discretion over 2020.

It should be noted that during early part of 2020 I was not formally the Society's WPA.

I have made a report to the Board in accordance with the requirements of the FCA Handbook to inform them of my view of the way in which the PPFM has been applied and how discretion has been exercised in respect of the with-profits policyholders.

The Society's own report notes a number of issues for with-profits policyholders to be aware of in relation to the PPFM for 2020. They relate to:

- The approach of segregating assets in the Order Insurance Fund for ethical policies.
- The approach of setting bonuses against gilt yields and forward-looking investment returns.
- Some assets allocations fell outside the investment ranges as a result of extreme market movements related to, and subsequent derisking following, the COVID-19 pandemic.
- There are a number of breaches in relation to the Society's payout ranges, mostly in POIS, caused by limitations within the administration systems which have since been addressed by the Society.
- The consideration of the prospective returns for with-profits TESP new business.

Based on the information and discussions with the Society I do not believe that these items will have caused any material issues or detrimental impacts for any group of policies or policyholders in general. Apart from these points, I can confirm that, in my opinion, the Board has acted in a manner consistent with the PPFM in the year from 1st January 2020 to 31st December 2020.

I can also confirm that, in my opinion, the Board has taken the interests of with-profits policyholders into account in a reasonable and proportionate manner.

Scott Robinson FIA
With-Profits Actuary

25 June 2021

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