

# Solvency and Financial Condition Report as at 31 December 2019

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## Introduction

This Solvency and Financial Condition Report (SFCR) has been prepared to assist members to understand the capital position of the Society.

The contents of the SFCR are prescribed by EU regulation and must contain the following sections:

SFCR Section	Description of Contents
Business and Performance	Information about the Society and a summary of business and financial performance over the year.
System of Governance	Information about the Society's organisational structure and system of governance, including risk management, internal control, internal audit and the actuarial function.
Risk Profile	Information about the key risks facing the Society and how these are managed.
Valuation for Solvency Purposes	Valuation of the Society's assets and liabilities in accordance with accounting standards and solvency rules, including details on the assumptions used to calculate them and the differences between them.
Capital Management	Information on the capital requirements of the Society in line with Solvency II regulations.

## Business and Performance

All of the Society's business risks and returns continued to be within one business segment i.e. long term with-profits regular savings plans with life and/or disablement cover.

Premium income was similar to the prior year at £4,425k (2018: £4,456k). Claims were also similar to the prior year at £4,187k (2018: £4,087k).

Operating costs were higher than in the prior year at £1,029k (2018: £975k). This increase primarily relates to standard inflationary increases to costs overall as well as specific expenditure on a new website and digital marketing initiatives.

Investment income was similar to the prior year at £1,046k (2018: £1,084k). During the year, there were net gains on the realisation of investments of £121k compared to net losses on the realisation of investments of £138k in 2018. There were also unrealised gains on investments of £1,950k as at 31 December 2019 compared to unrealised losses on investments of £1,173k as at 31 December 2018.

Since the year-end the Management Committee has assessed the potential implications of the COVID-19 pandemic on the Society's business and performance, including the impact on asset values, solvency, the possibility of increased levels of claims and surrenders and the possibility of short-term reductions in new business levels. As a result of this assessment, the Management

Committee has no material concerns relating to the effect of COVID 19 on the Society's viability. Further information is provided in section A5.

## System of Governance

The Society operates under the direction of the Management Committee, with day-to-day management responsibility delegated to the Chief Executive and other senior managers. The Society also has an Audit and Risk Management sub-Committee that deals with matters relating to financial and regulatory reporting, internal and external audit, internal control and risk management. The Society also has a With-Profits Advisory Arrangement whose role is to protect the interests of With-Profits policyholders and ensure that the With-Profits Fund is managed in accordance with the Principles and Practices of Financial Management.

The Society has strong risk management arrangements, including an Own Risk and Solvency Assessment process. This is a rolling process, under the governance of the Management Committee, that provides a detailed analysis of the Society's capital adequacy, risk management and forward-looking perspective.

The adequacy and effectiveness of the Society's risk management, internal control and governance processes are subject to periodic review by Internal Audit, which reports its findings and recommendations independently to the Audit and Risk Management sub-Committee.

## Risk Profile

The Society manages its risks to ensure that it can meet its obligations to policyholders as they fall due, whilst aiming to provide them with a reasonable return on their investment. The principal risks faced by the Society are:

- Life underwriting risk, which arises from the underwriting of the Society's policies and includes mortality, longevity, morbidity, lapse rates, expense levels and life catastrophe risk.
- Market risk, which is the risk that a financial instrument will fluctuate in value because of the volatility of market prices.
- Counterparty risk, which is the risk of potential losses due to unexpected default, or deterioration in the credit standing of counterparties and debtors.
- Liquidity risk, which is the risk that the Society, though solvent, does not have sufficient financial resources to meet its obligations as they fall due.
- Operational risk, which is the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events.

## Valuation for Solvency Purposes

The table overleaf summarises the Society's assets and liabilities in accordance with Financial Reporting Standards and Solvency II Regulations:

£000	31 December 2019	31 December 2018
Assets	36,133	33,678
Technical Provisions	26,763	26,733
Other Liabilities	473	253
Own Funds	8,897	6,692

The Society's assets increased due to an increase in market values. The Society's overall technical provisions are very similar to the prior year. The main reasons for the movement in technical provisions are set out in the Annual Report and Financial Statements note 18.

## Capital Management

The capital requirement is the amount that insurers are required to hold in excess of technical provisions. The table below summarises the Society's Own Funds, Capital Requirement and Free Assets in accordance with Solvency II Regulations:

£000	31 December 2019	31 December 2018
Own Funds	8,897	6,692
Capital Requirement	3,753	3,333
Free Assets	5,144	3,359

The Society's Own Funds have increased principally because the Society's asset values have increased.

The increase in the Solvency Capital Requirement is attributable to the following factors:

- An increase in the symmetric adjustment that must be applied to equity holdings following their increased value as at 31 December 2019; and
- An increase in the transitional element that applies to directly held equities purchased before January 2016, which increased year on year.

## Approval by the Management Committee

The Management Committee is responsible for preparing the Solvency and Financial Condition Report in accordance with the Prudential Regulation Authority (PRA) rules and Solvency II Regulations.

The members of the Management Committee confirm that, to the best of their knowledge,

- throughout the 2019 year, the Society has complied in all material respects with the requirements of the PRA rules and Solvency II Regulations as applicable, and
- it is reasonable to believe that, at the date of publication of the SFCR, the Society continues so to comply and will continue so to comply in the future.

By order of the Management Committee,



J W Goolamier, Chair

9 April 2020



M A Bicknell, Chief Executive

9 April 2020

## **A Business and performance**

### **A1 Business**

#### **A1.1 Corporate structure**

The Society, which was founded in 1865, is a mutual friendly society, incorporated under the Friendly Societies Act 1992. The registered number of the Society is 708F.

The Society is not part of a group and does not have any subsidiaries.

#### **A1.2 Business objectives**

The Society's principal activity is to provide savings plans with life assurance through endowment policies, which, in the case of those with relevant certification, can include cover against permanent disablement.

#### **A1.3 Registered office**

The registered office of the Society is:

727 Washwood Heath Road  
Ward End  
Birmingham  
B8 2LE

#### **A1.4 Regulators**

The Society is authorised by the Prudential Regulation Authority. The Society is regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

Prudential Regulation Authority  
Bank of England  
20 Moorgate  
London  
EC2R 6DA

Financial Conduct Authority  
12 Endeavour Square  
London  
E20 1JN

The Society, as a category 5 firm, is supervised through the smaller insurer regime at the Prudential Regulation Authority.

#### **A1.5 Auditors**

The statutory auditor of the Society is BHP LLP and can be contacted as follows:

BHP LLP  
2 Rutland Park  
Sheffield  
S10 2PD

## A1.6 Lines of business

All of the Society's business risks and returns are within one business segment i.e. long term with-profits regular savings plans with life and/or disablement cover. All of the Society's business is transacted in the United Kingdom, although members may move overseas subsequent to taking out a policy. The premium income is as follows:

£000	2019	2018
total gross premiums written	4,425	4,456

For Solvency II purposes, all the Society's activity is classed as 'Insurance with profit participation'.

## A1.7 Significant business events during the year

There were no significant business events during the year.

Further detail on the Society's business can be found in the Annual Report and Financial Statements.

## A2 Underwriting performance

### A2.1 Premiums and Claims

The table below shows the Society's premiums and claims for the year:

£000	2019	2018
gross premiums	4,425	4,456
reinsurers' share of premiums	0	0
gross claims	4,187	4,087
reinsurers' share of claims	0	0

Underwriting and reserving risks arise within with-profits business due to fluctuations in persistency, expenses and claims rates relative to the actuarial assumptions made in the pricing process. These risks are managed by the Society through its Underwriting Arrangements Policy. The permitted classes and characteristics of business to be written are discussed by the Management Committee at least annually. The capacity to accept new business is determined by the Society's available capital resources, in accordance with the Own Risk and Solvency Assessment process. The pricing of the Society's products is reviewed on a periodic basis, taking account of underwriting data and experience and in accordance with the professional advice of the Chief Actuary. The Society has robust underwriting arrangements in place, which include prospective policyholders being required to declare any pre-existing conditions and, in relation to disability plan business, to provide evidence that they carry out safety critical functions on the railway.

Due to the nature of business transacted, the Society does not use reinsurance arrangements. The Society's lack of reinsurance arrangements is consistent with its risk appetite. They are not required to mitigate the volatility of capital. There is therefore no allowance for reinsurance in the estimation of technical provisions. Exposure of the Society's portfolio to catastrophic claims experience is considered by the Management Committee on a periodic basis.

## A2.2 Operating Expenses

The Society's operating expenses are set out below:

£000	2019	2018
acquisition costs	188	157
administrative expenses	842	818
total operating expenses	1,029	975

The Society does not have any material leasing arrangements.

## A3 Investment performance

Performance for the year ended 31 December 2019 and for the prior year was as follows:

£000	Interest, dividends receivable and rent	realised gains/(losses)	unrealised gains/(losses)	total	total
	2019	2019	2019	2019	2018
government bonds	223	3	58	284	78
corporate bonds	308	5	312	625	(91)
Equities	205	20	914	1,139	(344)
Collectives	46	90	638	774	(204)
cash and cash equivalents	2	3	0	5	0
loans and mortgages	58	0	0	58	70
investment property	204	0	28	232	264
Total	1,046	121	1,950	3,117	(227)

Investment costs for the various categories were as follows:

£000	investment costs	
	2019	2018
government bonds	102	97
corporate bonds		
Equities		
Collectives		
cash and cash equivalents	0	0
loans and mortgages	0	0
investment property	17	17

## **A4 Performance of other activities**

The Society does not carry out any other activities.

## **A5 Other material information**

Since the year-end, the Society has seen the devastating impact on human life of the COVID-19 pandemic. As a result of fears over the spread of the virus and the impact of the containment measures being put in place, we have also seen severe downward pressure on share prices and significant stockmarket volatility.

At this point in time, it is too early to make firm predictions as to what the long-term impact will be on the Society's business and performance. This will depend on a number of factors, including the extent and duration of the period of disruption and the impact on the global economy and financial markets.

Following the market falls relating to COVID-19, the Society decided to adjust its final bonus rates and surrender value factors with the aim of continuing to pay a fair share to those claiming, thus treating all policyholders fairly. The Society's normal practice is to apply smoothing across the year, with its surrender value factors and final bonus rates only changed annually. However, the Society is receiving regular updates on the value of its investments and will change the rates again if justified by asset values rising or falling significantly.

The Society's products are not particularly sensitive to increases in mortality or morbidity, although it is possible that the current situation could lead to an increase in policyholders surrendering their policies. The Society holds a high proportion of its assets in government bonds and has no liquidity concerns if it were to have to pay out for higher than usual claims or surrenders. Policyholders wishing to surrender their policies are also offered policy loans, as an alternative, enabling them to continue to benefit from the guarantees on their policies and from future bonuses.

It is likely that there will be a reduction in new business volumes in the short term, but we do not anticipate this having a significant effect in the long term. However, it will be closely monitored as maintaining business volumes is key, given that expenses are largely fixed in nature.

The Society is in a good solvency position. At 31 December 2019, it had Own Funds of 237% of the Solvency Capital Requirement (SCR). Regular estimates of solvency are being made and Own Funds have remained significantly above the SCR at all points since the year-end. A recent approximation as at 31 March 2020 showed the Society had Own Funds of approximately 216% of the SCR. The Society's investments, which are approximately two-thirds bonds, with the remainder mostly in equities plus some property and deposits, have held up well to the market falls with assets at 31 March 2020 approximately 6% below the 31 December 2019 values.

We will continue to closely monitor the impact of COVID-19 on the operating performance of the Society. We will also continue to closely monitor the valuation of assets and the valuation of technical provisions, which are sensitive to movements in risk-free rates. An updated valuation will be carried out and reported to the PRA in the quarterly returns at 31 March 2020. We have no material concerns relating to the effect of COVID-19 on the Society.

## **B System of governance**

### **B1 General information on the system of governance**

The Society operates under the direction of the Management Committee, with day-to-day management responsibility delegated to the Chief Executive and other senior managers. The strategic direction of the Society, performance against annual and long-term plans and targets, monitoring of the business and reviewing the work of sub-Committees is within the remit of the Management Committee.

The core responsibilities of the Management Committee are to:

- ensure that the Society operates within an effective system of internal control, risk management, governance and compliance,
- ensure that the solvency capital requirement and minimum capital requirement are maintained at all times,
- determine the strategy and approve the Business Plan,
- ensure that the business is conducted in an efficient and effective manner and that the interests of members are at the heart of everything the Society does, and
- support key persons, including those subject to the Senior Managers and Certification Regime, to discharge their responsibilities in respect of the area of the business for which they are responsible.

There are certain decision-making powers that are reserved for the Management Committee. These include:

- declaration of bonus rates,
- approval of the Annual Report and Financial Statements,
- approval of the Own Risk and Solvency Assessment (ORSA),
- setting the remuneration of the Society's Chief Executive and other senior managers,
- appointment and dismissal of the Chief Executive,
- approval of the Business Plan and budgets,
- acquisition and disposal of significant assets.

At the end of 2019, the Management Committee comprised a Chair, Chief Executive, two Non-Executive Professional Directors and five Non-Executive Member Directors. A 'Professional Director' is classed as one who possesses an appropriate professional qualification or has recent and relevant experience within the financial services industry. A 'Member Director' is classed as one who is drawn directly from the membership and has a knowledge of the railway industry in which the Society operates. The Management Committee considers that the balance of knowledge, experience, skills and independence is appropriate although it continues to monitor the situation to comply with regulatory requirements and to reflect the Society's strategy. The Society also has an Audit and Risk Management sub-Committee and a With-Profits Advisory Arrangement. The Chief Executive is responsible for overseeing all activities of the Society and refers material matters to the Management Committee.

## **B1.1 Membership of the Management Committee**

The following individuals were members of the Management Committee as at 31 December 2019:

J W Goolamier	Chair
J McKenna	Deputy Chair & Chair of With-Profits Advisory Arrangement
L P Davies	Senior Independent Director
M A Casey	Chair of Audit and Risk Management sub-Committee
M A Bicknell	Chief Executive
R T Brushfield-Hodges	
A Edwards	
D I Storrie	
R A J Townsley	

## **B1.2 Audit and Risk Management sub-Committee**

The main responsibilities of the Audit and Risk Management sub-Committee are to:

- review the effectiveness of the Society's financial and regulatory reporting,
- review the system of internal control,
- review the arrangements for identifying and evaluating risks in relation to the Society's current and future activity in accordance with the Business Plan,
- monitor the effectiveness of the external audit function including a review of the external auditor's appointment, fees and independence, and
- monitor the role and effectiveness of the internal audit function, including a review of the internal auditor's appointment, fees and independence.

The Audit and Risk Management sub-Committee met four times during the year. The sub-Committee has unfettered access to both the internal and external auditors and, equally, the audit firms have right of access to the sub-Committee and to the Management Committee as deemed appropriate. In addition to monitoring the external audit from the outset of the planning stage, the sub-Committee also considers the significant findings and recommendations arising from the audit of the Society's Annual Report and Financial Statements.

The Audit and Risk Management sub-Committee has a responsibility to consider the key areas of judgement in the Financial Statements. As part of the process for agreeing the 2019 Financial Statements, the sub-Committee considered reports prepared by the Chief Actuary relating to the basis, assumptions and methodology for the calculation of the year-end technical provision and solvency capital requirement.

It is considered that the members of the sub-Committee possess the necessary mix of skills and knowledge of the Society to enable them to exercise appropriate judgements and bring challenge and debate to issues as appropriate.

The Terms of Reference of the Audit and Risk Management sub-Committee are available on the Society's website.

### **B1.3 Membership of the Audit and Risk Management sub-Committee**

The following individuals were members of the Audit and Risk Management sub-Committee as at 31 December 2019:

M A Casey                      Chair

J McKenna

D I Storrie

R A J Townsley

### **B1.4 With-Profits Advisory Arrangement**

The purpose of the With-Profits Advisory Arrangement (WPAA) is to protect the interests of With-Profits policyholders and ensure that the With-Profits Fund is managed in accordance with the Principles and Practices of Financial Management (PPFM). The WPAA is advisory in nature i.e. it is not a decision-making body; instead, its role is to inform the decision making of the Management Committee.

The main responsibilities of the WPAA are to:

- assess, report on and provide advice to the Management Committee on the manner in which the With-Profits business is administered in accordance with the PPFM,
- review the way in which the Management Committee exercises its discretion in the management of the With-Profits Fund including matters relating to the calculation and application of asset shares, smoothing and bonus calculations,
- challenge any significant changes to the risk profile or investment strategy of the Society, and
- assess the performance of the With-Profits Actuary.

The WPAA met three times during the year. The WPAA has unfettered access to the With-Profits Actuary and, equally, the With-Profits Actuary has open access to the WPAA and Management Committee as deemed appropriate.

The Terms of Reference of the WPAA and the PPFM are available on the Society's website.

### **B1.5 Membership of the With-Profits Advisory Arrangement**

The following individuals were members of the With-Profits Advisory Arrangement as at 31 December 2019:

J McKenna                      Chair

M A Casey

L P Davies

A Edwards

## B1.6 Key functions

The Society follows ‘fit and proper person’ principles to ensure that key functions are led by appropriately skilled people. All outsourced services are reviewed periodically and, when considered appropriate, are re-tendered or re-negotiated.

Key Function	Provider	Key roles and responsibilities and how they report to the Management Committee
Internal Audit	outsourced – CK Chartered Accountants	<p>The Internal Audit function is delivered through an outsourced arrangement by a regional firm of Chartered Accountants.</p> <p>The purpose of Internal Audit is to provide the Audit and Risk Management sub-Committee with assurance that the Society’s risk management, internal control and governance arrangements are operating effectively to protect the assets, reputation and sustainability of the Society.</p> <p>The Chair of the Audit and Risk Management sub-Committee has regulatory responsibility for safeguarding the independence and oversight of the performance of the Internal Audit function.</p> <p>Further information regarding Internal Audit is contained in section B5.</p>
Risk Management	in-house	<p>The Risk Management function is delivered in-house.</p> <p>The Finance Manager, as Chief Risk Officer (SMF 4), has responsibility for the Society’s overall risk management arrangements and reports to the Audit and Risk Management sub-Committee in this capacity.</p> <p>Further information regarding Risk Management is contained in section B3.</p>
Actuarial	outsourced – SDA LLP	<p>The Actuarial Function is delivered through an outsourced arrangement. The roles of Chief Actuary (SMF 20) and With-Profits Actuary (SMF 20a) are currently held by the same person. The Chief Actuary reports to the Management Committee and the Audit and Risk Management sub-Committee. The With-Profits Actuary reports to the Management Committee and the With-Profits Advisory Arrangement.</p> <p>Further information regarding the Actuarial Function is contained in section B6.</p>

Key Function	Provider	Key roles and responsibilities and how they report to the Management Committee
Compliance	in-house	<p>The Compliance Function is delivered in-house with external support as and when required. Regulatory responsibility for the Compliance Oversight Function (SMF 16) is held by the Chief Executive. The Chief Executive reports any significant compliance issues to the Management Committee.</p> <p>The Chief Executive is also the Society's Money Laundering Reporting Officer (SMF 17).</p> <p>Further information regarding the compliance function is contained in section B4.</p>

### **B1.7 Changes to system of governance during 2019**

There were no changes to the system of governance during 2019.

### **B1.8 Remuneration policy**

The principles underlying the remuneration policy of the Society apply to all employees. These include the following:

- the remuneration package needs to be sufficient to attract and retain high-calibre individuals, whilst demonstrating value for money to the Society,
- the remuneration package should be appropriately constructed so that it contributes to the retention and motivation of key individuals,
- remuneration packages should reflect the individual's role and responsibilities.

All employees receive a fixed salary that is appropriate to their role. The Society does not use annual bonuses, long-term incentive plans or any other form of variable pay structure. All employees are eligible to join the Society's Group Personal Pension Scheme. The Society does not operate supplementary pension or enhanced early retirement arrangements.

Non-Executive Directors of the Management Committee are remunerated by way of an annual fee and a meeting attendance allowance. In addition, reasonable expenses incurred in the course of Society business are reimbursed. Non-Executive Directors are not entitled to join the Pension Scheme.

### **B1.9 Transactions with Committee Members, Officers and their close family members**

The following transactions have been undertaken as part of the normal business of the Society. These transactions were originally made on the same terms and conditions as applicable to other members of the Society, or on commercial terms.

life assurance policies	2019 persons	2019 amount £	2018 persons	2018 amount £
premiums paid during the year	11	28,035	11	28,033
total sum assured at 31 December	11	343,323	10	336,971

Commission payments of £4,368 (2018: £2,086) were made in 2019 to some Committee members in relation to their duties as Depot Introducers.

During the year, Mr R T Brushfield-Hodges was paid £5,870 (2018: £4,585) for consultancy services provided to the Society.

## **B2 Fit and Proper requirements**

### **B2.1 Skills, knowledge and expertise**

The Society has arrangements in place to ensure that its Management Committee and Senior Managers collectively possess the skills, qualifications and experience to provide sound and prudent management of the Society. The key areas of knowledge are:

- insurance and financial services,
- business strategy and business model,
- solvency II requirements,
- financial and actuarial understanding,
- statutory and regulatory requirements.

Management Committee evaluation is carried out periodically to ensure that those charged with the Society's governance possess the attributes required in the regulated financial services industry. Skills gaps or areas for development that are identified through this process are addressed through the provision of training or, where appropriate, through the recruitment of additional Committee members.

### **B2.2 Fitness and propriety of persons**

The Society has arrangements in place to ensure that its Management Committee and Senior Managers meet the regulatory 'fit and proper' requirements. The following factors are taken into account when deciding whether an individual is fit and proper:

- honesty, integrity and reputation,
- competence and capability,
- financial soundness.

The Society employs the following procedures, as deemed appropriate to the nature of the appointment, to assess fitness and propriety:

- annual self-declaration,
- credit reference agency checks,
- professional qualifications check,
- FCA Register search.

### B2.3 Controlled Function holders

The following persons were responsible as at 31 December 2019 for carrying out the controlled functions:

Controlled Function		name
SMF 1	Chief Executive Officer	Marc Bicknell
SMF 2	Chief Finance Officer	Lynsey Inglis
SMF 4	Chief Risk Officer	Lynsey Inglis
SMF 5	Head of Internal Audit	Marc Bicknell
SMF 9	Chair of the Governing Body	Joe Goolamier
SMF 11	Chair of the Audit Committee	Moira Casey
SMF 14	Senior Independent Director	Lee Davies
SMF 20	Chief Actuary	Alison Carr
SMF 20a	With-Profits Actuary	Alison Carr
SMF 16	Compliance Oversight	Marc Bicknell
SMF 17	Money Laundering Reporting	Marc Bicknell

## B3 Risk management system including Own Risk and Solvency Assessment

### B3.1 Risk management framework

Effective risk management is fundamental to the Society's strategy as it protects members' funds, ensures the efficient use of capital and helps to deliver the Business Plan. The Society manages its risks within a defined framework. The framework comprises the Risk Appetite Statement, the Capital Assessment of Risks and the Risk Register. Ultimate responsibility for identifying and managing the risks faced by the Society rests with the Management Committee whilst the Audit and Risk Management sub-Committee has responsibility for the detailed scrutiny of risk management issues.

### B3.2 Risk identification

The Society assesses its risks on an ongoing basis throughout the financial year. Key risks, and the mitigating actions and controls in place to manage the risks, are recorded in the Risk Register, which is maintained by the Finance Manager, in her capacity as Chief Risk Officer.

### B3.3 Risk appetite, tolerances and limits

The Society's Risk Appetite is determined by the Management Committee and is reviewed on a regular basis as new risks emerge, or at least annually. The Risk Appetite Statement is translated into risk thresholds and risk trigger points, which are used to manage the Society's solvency.

### B3.4 Three Lines of Defence

The Society has adopted Three Lines of Defence principles in its risk management framework. The First Line of Defence is the management activity, checking and validation carried out in accordance with policies and procedures. The Management Team, led by the Chief Executive, is responsible for the First Line of Defence. The Second Line of Defence is the Risk Management function, which seeks to ensure conformity with risk, actuarial and compliance policies and procedures. The Finance Manager, as Chief Risk Officer, is responsible for the Second Line of Defence. The Third Line of Defence is the Internal Audit function, which provides an independent, objective and critical assessment of the design and effectiveness of the Society's internal control, risk management and governance arrangements.

### B3.5 Own Risk and Solvency Assessment (ORSA)

The Society's ORSA is a rolling process that provides a detailed analysis of the Society's capital adequacy, risk management and forward-looking perspective. This is achieved using a combination of internal, actuarial and regulatory documents and information to report appropriately on the Society's financial position. The ORSA is carried out in accordance with the ORSA Policy agreed by the Management Committee. The intention of the Society's ORSA is to develop an understanding of the risks that the Society is exposed to and the associated capital requirements, thereby improving business decision-making processes.

### B3.6 Capital requirements

A key element of the ORSA is an assessment of the Society's capital requirements. The Society uses the standard formula methodology as outlined in the Delegated Text and associated guidelines. Further information on this is provided in section E.

### B3.7 Own Risk and Solvency Assessment programme of review

The ORSA is undertaken throughout the year in a way that is dovetailed with the business decision-making cycle, culminating in an annual ORSA submission to the Prudential Regulation Authority. The scheduled review programme for the various elements of the ORSA is as follows:

section of ORSA	frequency of review
Financial Performance	three times per year
Risk Appetite Statement	annually
Capital Assessment of Risks	annually
Risk Register	annually
Business Plan	annually
Actuarial Reporting: <ul style="list-style-type: none"><li>• Solvency II Technical Provisions and Capital Requirements</li><li>• Forward Looking Assessment of Solvency</li></ul>	annually
Investment Policy	annually
Corporate Control Manual	annually

In addition, the ORSA is considered if any significant events occur or risks emerge that could impact the ability of the Society to achieve its Business Plan. Examples of significant events or emerging risks could include:

- significant falls in asset values,
- significant reduction in the risk-free discount rate, potentially leading to increased technical provisions,
- increase in the sterling value of the Minimum Capital Requirement,
- mass surrenders of policies.

### **B3.8 Governance of the ORSA**

The Management Committee has ownership and ultimate responsibility for the ORSA, including the appropriateness and completeness of the processes and procedures and the approval of the disclosures and submissions to the Prudential Regulation Authority. The Society's Finance Manager carries out the Senior Manager Function of Chief Risk Officer and as such is responsible for the maintenance of the Society's risk management processes and procedures, for the accuracy of the financial data underlying the ORSA and for ensuring the continuous adequacy of the solvency of the Society through appropriate capital management. The Chief Actuary has a key role in the preparation of specific reports in the ORSA and for the provision of technical actuarial advice.

## **B4 Internal control and compliance arrangements**

### **B4.1 Internal control system**

The Society's internal control arrangements are designed to provide reasonable assurance as to the reliability of the Society's financial reporting, to ensure compliance with applicable statutory and regulatory requirements and to provide for the economic, efficient and effective management of the Society's business. The Management Committee has ultimate responsibility for the maintenance of adequate and effective internal control, risk management and governance arrangements. It is supported in this by the Audit and Risk Management sub-Committee. Operational responsibility for the design and maintenance of the internal control system rests with the Chief Executive and other senior managers. The Society's internal control arrangements are subject to annual review by the Internal Audit function, the results of whose work is reported to the Audit and Risk Management sub-Committee.

The Society's Financial Statements are subject to strong internal controls in their preparation prior to audit by the Society's statutory auditor. They are also subject to detailed scrutiny by the Audit and Risk Management sub-Committee and formal approval by the Management Committee ahead of submission to the Regulator and publication to the membership. The technical provisions and capital requirement are calculated by the Chief Actuary and are subject to scrutiny by a reviewing actuary, who is appointed by the statutory auditor. Key elements of the Society's internal control system include:

Reconciliation procedures	These include the preparation and review of bank reconciliations and the reconciliation of the general ledger.
IT controls	These include processing controls, security of data and systems, authorisation and access controls, back up procedures, anti-virus, firewall protection, disaster recovery arrangements, control over systems developments and changes and business continuity planning.
Management information	This includes the monthly reports prepared for the Management Committee on investments, new business volumes, claims and performance against budget.
Segregation of duties	This includes the processes for the initiation and authorisation of payments.
Data controls	This includes the checking and reconciliation of policy data to ensure the completeness and accuracy of the data upon which the actuarial valuation is undertaken.
Physical security	This includes the access to the office premises and the locking away of cheque books and other valuable or sensitive documents.

## **B4.2 Implementation of the Compliance Function**

The compliance function is delivered in-house with external support as and when required. Regulatory responsibility for the Compliance Oversight Function (SMF 16) rests with the Chief Executive.

The Society employs a retail sales compliance officer to undertake checks on sales made through the Area Representative network.

The Society periodically commissions a review of its compliance arrangements by an external consultant.

## **B5 Internal Audit Function**

### **B5.1 Implementation of the Internal Audit Function**

Internal Audit is an independent, objective assurance and consulting activity designed to add value and improve the Society's operations. It helps the Society accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal Audit is currently delivered under an outsourced arrangement by CK LLP, a regional firm of Chartered Accountants.

All of the Society's activities (including outsourced activities) are within the scope of Internal Audit. Internal Audit carries out an Audit Needs Assessment (ANA) to determine which areas of activity need to be subject to internal audit scrutiny and the frequency with which a review is carried out over the cycle of the Internal Audit strategy. The ANA is used to direct internal audit resources to those areas of the Society's operations that are assessed as generating the greatest risk to the achievement of its objectives. Internal Audit takes a risk-based approach and does not necessarily have to cover all of the potential scope areas every year. Its focus may change in light of emerging risks and Internal Audit's ongoing assessment of risk. Internal Audit can also, where appropriate,

undertake special investigations and consulting arrangements at the request of the Audit and Risk Management sub-Committee, Management Committee or regulators. Internal Audit seeks to co-ordinate its activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimise duplication of efforts.

## **B5.2 Independence of the Internal Audit Function**

The Internal Audit function derives its authority from the Management Committee through the Audit and Risk Management sub-Committee. The Internal Audit function is authorised by the Audit and Risk Management sub-Committee to have full and complete access to any of the Society's records and personnel. The Internal Audit function, under the governance of the Audit and Risk Management sub-Committee, is free to decide which audits to perform, the scope, frequency and timing of its work, the procedures it follows and the content of its reports. The Internal Audit function does not have any operational responsibility or authority over any of the activities audited. It is not responsible for the implementation of internal controls, the development of procedures, the installation of systems, the preparation of regulatory submissions or any other activity that may impair, or be perceived to impair, its objectivity.

The Chair of the Audit and Risk Management sub-Committee has regulatory responsibility for safeguarding the independence and oversight of the performance of the Internal Audit function.

## **B6 Actuarial Function**

The Society has an Actuarial Function, which is wholly outsourced. The roles of Chief Actuary (SMF 20) and With-Profits Actuary (SMF 20a) are held by Mrs. A E Carr of SDA LLP. Mrs. Carr is a Fellow of the Institute and Faculty of Actuaries.

The specific responsibilities of the Chief Actuary are to:

- calculate the Society's Technical Provisions and Solvency Capital Requirement,
- assess the suitability of using standard formula methodology to calculate the Society's Solvency Capital Requirement,
- undertake the risk modelling underlying the calculation of the capital requirements of the Society,
- prepare the Society's Forward-Looking Assessment of Solvency and
- issue an opinion on the adequacy of the Society's underwriting policy and reinsurance arrangements.

The specific responsibilities of the With-Profits Actuary are to:

- advise the Management Committee on key aspects of discretion to be exercised in the administration of the With-Profits Fund,
- advise the Management Committee as to whether the assumptions used to calculate the future discretionary benefits within the technical provisions are consistent with the Principles and Practices of Financial Management,
- report to the Society's With-Profits policyholders as to whether the discretion exercised by the Society in respect of the period covered by the Annual Report may be regarded as taking the interests of the relevant classes of the Society's With-Profits policyholders into account in a reasonable and proportionate manner.

## **B7 Outsourcing**

The policy of the Society is that its core policy administration, information systems and finance functions are managed in-house. Outsourcing is generally restricted to key areas where either professional expertise is not available from within the Society's own resources or where third-party provision of a service or function is preferable, for example to help demonstrate independence.

The key areas where functions are currently outsourced are:

- Internal Audit
- Actuarial function
- Investment Fund Management
- Investment Property Management

All outsourced providers are based in the United Kingdom.

In determining the award of an outsourced contract the Society undertakes due diligence to establish a provider's financial stability and track record in providing similar services. In this regard, references are sought from amongst the Society's friendly society peer group.

When the Society enters into outsourced arrangements, contracts for services, except in exceptional circumstances, do not extend beyond one year. Notice periods are normally one year or less, depending on the nature of the services. All outsourced services are reviewed periodically and, when considered appropriate, are re-tendered or re-negotiated.

## **B8 Assessment of system of governance**

The Society has performed a self-assessment of its system of governance against the requirements of the Corporate Governance Code issued by the Association of Financial Mutuals. Further information regarding the outcome of this self-assessment is contained in the Report on Corporate Governance within the Society's published Annual Report and Financial Statements.

## **B9 Other material information**

No other material information is necessary to give a full picture of the Society's system of governance.

## **C Risk Profile**

### **C1 Risk management framework**

The Society manages its risks within a defined framework. The framework comprises the Risk Appetite Statement, the Capital Assessment of Risks and the Risk Register. Ultimate responsibility for identifying and managing the risks faced by the Society rests with the Management Committee whilst the Audit and Risk Management sub-Committee has responsibility for the detailed scrutiny of risk management issues. The Finance Manager, as Chief Risk Officer (SMF 4), has responsibility for the Society's overall risk management arrangements, including the maintenance of adequate levels of solvency.

### **C2 Prudent Person Principle**

The Society invests its assets in accordance with the 'prudent person principle' as set out in Article 132 of the Directive 2009/138/EC. The fund manager operates in accordance with the Investment Policy, which specifies the type of investments that they are allowed to invest in, the minimum and maximum proportions allowable, the maximum exposure to overseas holdings, the required modified duration of bonds and their levels of credit rating. The Society's Management Committee undertakes regular reviews of the performance of the fund manager and reviews the Investment Policy at least annually. The Society's Principles and Practices of Financial Management (PPFM) document sets out how the Society conducts its With-Profits business. The PPFM makes reference to the Investment Policy of the Society, the purpose of which is to maximise the overall return of the investments of the Society subject to ensuring that guarantees are met through maintaining adequate solvency and liquidity.

### **C3 Loans portfolio**

As at 31 December 2019, the Society had loans secured by mortgages of £36,584 (2018: £277,242).

As at 31 December 2019, the Society had policy loans of £908,278 (2018: £944,736). Policy loans are available members as an alternative to early surrender of their policies. Premiums continue to be collected until the maturity date or earlier death or disability of the life assured. Interest is charged based on the rate set by the Management Committee. The loan amount is then deducted from the policy proceeds at maturity or when a death or disablement payment is made.

### **C4 Risk sensitivity**

For the key risks that the Society is exposed to, the sensitivity of the Society's surplus assets is investigated annually.

### **C5 Overview of key risks**

An overview of the principal risks associated with the business including an outline of how they are each managed is provided below.

## C5.1 Life Underwriting risk

Life underwriting risk considers the risks arising from the underwriting of the Society's policies. For each risk, the stress is considered only for those policies where this increases the technical provisions. The Solvency Capital Requirement for life underwriting risk is quantified in section E2.2.

### C5.1.1 *Mortality*

This stress covers the loss or change in technical provisions following a permanent 15% increase in the expected mortality rates.

### C5.1.2 *Longevity*

This stress covers the loss or change in technical provisions following a permanent 20% decrease in the expected mortality. As the effect for the Society is to reduce liabilities and have no effect on assets, the stress is therefore assumed to be nil.

### C5.1.3 *Morbidity*

This stress covers the loss or change in technical provisions following a permanent increase in expected morbidity. The disability inception stress is based on a 35% increase in disability claims in the first 12 months from the valuation date and then 25% thereafter.

### C5.1.4 *Lapse*

This stress covers the loss or change in technical provisions as a result of the change in the expected exercise rate of policyholder surrenders and lapses.

The lapse stress is based on three scenarios, with the scenario having the greatest impact on total liabilities being used to calculate the additional capital to cover lapse risk:

- future lapses 50% higher than expected
- future lapses 50% lower than expected
- mass lapse of 40% of in-force business, i.e. a one-off event

Previously for the risk margin calculation, the scenario giving the greatest impact for each policy separately was used, which overstated the risk margin. This year the modelling has been amended to use the higher overall scenario.

### C5.1.5 *Expense*

This stress covers the risk of expense levels of administering the in-force policies being higher than assumed. This can arise from an increase in expenses through inflation or unexpected costs. The expense stress is a permanent 10% increase in administration expenses plus a 1% increase per annum in expense inflation.

### C5.1.6 *Life Catastrophe*

This stress covers the risk of loss, or of adverse change in the value of the technical provisions, resulting from the significant uncertainty of pricing and provisioning assumptions related to

outbreaks of major epidemics, as well as the unusual accumulation of risks under extreme circumstances.

The life catastrophe stress is a 0.15% increase in mortality rates, for the next twelve months, for each policy where the payment of benefits is dependent on the policyholders' survival or death.

The Delegated Act does not require the application of a morbidity catastrophe stress for health insurance that has not been unbundled from life assurance.

#### **C5.1.7 *Correlation***

The Delegated Act takes into account the diversification within the life underwriting risks by using a correlation matrix. This is because it is unlikely that all these risks (major and individual) will occur simultaneously.

#### **C5.1.8 *Life Underwriting risk mitigation***

This Society's approach to underwriting aims to protect members from external anti-selection factors and means that if a policyholder has a pre-existing condition, they would not be able to claim for death or disablement due to that condition.

### **C5.2 *Market risk***

Market risk is the risk that the value of a financial instrument will fluctuate because of the volatility of market prices. Exposure to market risk is measured by the impact of movements in the level of financial variables such as stock prices, interest rates, property prices and exchange rates.

The market risk module considered for the Society's asset portfolio consists of the asset stresses described below, with the Solvency Capital Requirement for market risk quantified in section E2.3.

#### **C5.2.1 *Interest rate***

This stress allows for movements in the risk-free rates used for discounting within the calculation of technical provisions. The risk-free rate term structures are provided by EIOPA on a monthly basis. The impacts of the change in risk-free rates are measured against both the assets and liabilities to give a net impact. The net impact (up or down movement) which generates the greatest capital requirement allowing for loss absorbency of technical provisions is then used for the capital requirement before loss absorbency.

#### **C5.2.2 *Equity***

The Delegated Act requires an immediate fall of 39% plus a symmetric adjustment for equities listed on regulatory markets in countries that are members of the EEA or OECD (and 49% for other equities). However, the Society has taken advantage of Article 308b of Omnibus 2 section 9a to apply a transitional adjustment to the standard stress. This allows equities listed on regulated markets in countries that are members of the EEA or OECD and bought before 1 January 2016 to have a lower stress, which then moves from 22% at 31 January 2016 up to 39% plus symmetric adjustment over the seven year period after 1 January 2016. However, equities purchased after 1 January 2016 have the full equity stress of 39% / 49% plus symmetric adjustment.

LGT Vestra, the investment manager, has supplied the Society with details of which direct assets were bought after 1 January 2016 and thus have the full equity stress applied. For collective investments, it has been assumed that all equities were purchased after 2015.

As at 31 December 2019 the symmetric adjustment was calculated as -0.08%

### C5.2.3 *Property*

The asset stress allows for an instantaneous fall of 25% in the value of property, including property held via collective investment schemes. The Society owns four properties for investment purposes, along with its head office. Additionally, the Society owns shares in Real Estate Investment Trusts (REITs). A REIT is a company that invests wholly in physical real estate, so this investment is treated as property rather than equity for the purposes of determining the SCR.

### C5.2.4 *Currency*

The currency risk takes into account the impact of a sharp rise or fall in currency exchange rates. The currency stress allows for an instantaneous fall of 25% in the sterling market value of non-sterling assets.

The currency forwards held are assumed to be part of a continuing rolling hedge strategy, to be within the Society's investment policy and well understood by the Society and its investment managers and are therefore allowed within the calculations.

### C5.2.5 *Spread*

The spread is an additional return over the risk-free rate earned on bonds and is a representation of the riskiness of bond returns. The spread risk considers the impact of bond spreads increasing. It takes into account the term of assets and liabilities. Bonds that are not risk-free are normally considered to have two spreads over the risk-free yield. The liquidity spread is compensation for investors for non-risk-free bonds not usually being traded in such high volumes as risk-free bonds such as government bonds and hence not being as easy to sell. The credit spread is compensation for investors for the possibility of the bond issuer defaulting.

All financial instruments that provide a predetermined income stream will be sensitive to the risk of the credit spread increasing. An increase to the credit spread does not have an impact on the value of the liabilities as they are valued using a risk-free rate.

The Delegated Act defines a set of spread increase stresses based on the duration to maturity and the current credit rating of the issuer.

### C5.2.6 *Concentration*

Concentration risk considers the impact of a large exposure with a particular counterparty. This exposure may result from holding a number of different asset classes with a single counterparty.

### **C5.2.7 *Correlation***

The Delegated Act takes into account the diversification within the asset portfolios by using a correlation matrix. This is because it is unlikely that all these risks (major and individual) will occur simultaneously.

### **C5.2.8 *Market risk mitigation***

The Society normally calculates its solvency position weekly or more frequently if circumstances require it. If the free assets fell below the trigger point for action then the Society would consult with the Investment Manager and Chief Actuary with a view to realigning the investment portfolio so that the Society's risk threshold was not breached.

## **C5.3 *Counterparty risk***

The counterparty risk module considers the risk of potential losses due to unexpected default, or deterioration in the credit standing of counterparties and debtors over the ensuing year. The method given within the Delegated Act assesses the probabilities of default and losses given default based on current credit ratings. The exposures considered are split into types 1 and 2. Type 1 exposures include cash deposits at banks whilst type 2 exposures include policy holder debtors and residential mortgage loans. The capital requirements for type 1 and type 2 exposures are calculated separately and then used to calculate an overall SCR counterparty risk allowing for diversification. The Solvency Capital Requirement for counterparty default risk is quantified in section E2.4.

### **C5.3.1 *Counterparty risk mitigation***

Counterparty default risk in relation to financial investments is managed by ensuring that the fund manager avoids excessive exposure to any one single counterparty. Additionally, the maximum exposure to fixed income holdings of different ratings is specified to ensure that the Society is not exposed to undue risk.

## **C5.4 *Liquidity risk***

Liquidity risk is the risk that the Society, though solvent, does not have sufficient financial resources to enable it to meet its obligations as they fall due. The Society's exposure to liquidity risk is considered to be low, since it maintains a high level of liquid assets to meet its liabilities. The only significant investments that are considered illiquid are the investment properties.

The Solvency Capital Requirement does not include any allowance for liquidity risk.

## **C5.5 *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 capital requirement for operational risk uses a formulaic approach based on either office premiums or technical provisions, which is quantified in section E2.6.

The operational risks include:

- Compliance – the risk of not meeting legal or regulatory requirements, including Conduct of Business rules, anti-money laundering and data protection.
- Business Continuity – the risk of inability to provide service to members due to events beyond the Society’s control, including failure of ICT systems or disruption to head office.
- Staff – the risk to the Society’s operations as a result of staff turnover or non-availability of key staff.
- Fraud – the risk of members’ funds being misappropriated.
- Outsourcing – the risk of a service provider failure or non-performance.
- Reputation – the risk of the Society suffering from adverse publicity.
- Customer Services – the risk of complaints and poor customer outcomes arising from delays, errors and omissions.

## **C6 Other material risks**

The Society does not sell or re-pledge collateral within the meaning of Article 214 of the Delegated Act.

The Society has not entered into securities lending or borrowing transactions, repurchase or reverse repurchase agreements as referred to in Article 4(1)(82) of Regulation (EU) No 575/2013.

The Society does not sell variable (or any other) annuities.

No further material risks have been identified.

## **C7 Other material information**

No other material information is necessary to give a full picture of the Society’s risk profile.

## D Valuation for solvency purposes

### D1 Valuation of assets

The table below details the basis for the Society's Solvency II asset valuation for each material class of assets. Assets are measured on a market value basis as at 31 December 2019.

£000	Solvency II	Financial Statements
Property	3,385	2,920
Financial Investments	29,681	30,308
Loans and Mortgages	945	945
Cash and cash equivalents	1,423	1,261
Insurance receivables	249	249
Any other assets, not elsewhere shown	450	450
Total assets	36,133	36,133

#### D1.1 Property

For Solvency II purposes the properties have been valued at fair value, this is the same basis as the Financial Statements, which follow UK GAAP. Full valuations are made by an independent, professionally qualified surveyor, on an annual basis.

For Solvency II purposes, any Real Estate Investment Trusts (REITs) held directly have also been included in the property asset category. The REIT value is taken at market value as at 31 December 2019 and then increased by the loan to value ratio. The increased value is assumed to be supplemented by cash deposits.

#### D1.2 Financial Investments

The Society's investments are valued at fair value. Fair value is the quoted mid-market value as at 31 December 2019.

The separate financial investment categories have been analysed in the following table.

	Solvency II £'000	Financial Statements £'000
Government bonds	10,512	8,867
Fixed interest securities	9,597	10,573
Directly held equities	9,572	6,163
Collectives	0	4,705
Total financial investments	29,681	30,308

The differences between Solvency II and the Financial Statements can be analysed as follows:

- The Government bonds figure in the Financial Statements includes only UK government bonds whereas for Solvency II purposes any European approved government bonds are also shown in this asset category.
- The difference between fixed interest securities in the Financial Statements and the Solvency II value is mainly due to the European approved government bonds being reclassified as government bonds for Solvency II purposes. In addition, £669k of collective investments have been reclassified as fixed interest securities.
- The difference in equities relates to the majority of assets held in collectives being classed as equities for Solvency II purposes. Also, a REIT shown in the Financial Statements as a directly held equity is classed as an investment property for Solvency II purposes.
- All collective investments have been reclassified as one of the following; equities, fixed interest securities, REIT (therefore classed as property) or cash, leaving this investment category with a value of £nil for Solvency II purposes.
- The difference between the total financial investments relate to the transfer of a REIT investment from equities to investment property and the collective investments holding deposits as underlying assets being shown in cash and cash equivalents for Solvency II purposes.

The financial investments are managed by LGT Vestra LLP. The fund aims to generate returns whilst ensuring the long-term liabilities of the Society are sufficiently covered by the asset mix and duration of the portfolio.

### **D1.3 Loans and Mortgages**

Loans and mortgages are valued on the same basis for Solvency II purposes as they are in the Financial Statements.

### **D1.4 Cash and Cash Equivalents**

Cash and cash equivalents are valued at carrying value on 31 December 2019. A reduction has been applied to the cash and cash equivalents under Solvency II for the gearing of the REITs. It is assumed that the difference between market value and the underlying Solvency II value would be financed by a reduction in cash. There are also some collective investments that hold deposits as underlying assets and these have also been included in the cash and cash equivalents value for Solvency II purposes.

### **D1.5 Other Assets**

All other assets, including insurance receivables, are valued for Solvency II purposes on the same basis as the Financial Statements, at fair value or settlement value.

### **D1.6 Recognition and Valuation Basis**

There has been no change to the recognition or valuation basis of assets for Solvency II purposes during the reporting period.

## D2 Valuation of technical provisions

### D2.1 Results

All of the Society's business is classified as one line of business. The total technical provisions are shown below:

£000	31 December 2019
best estimate	25,739
risk margin	1,024
technical provisions	<b>26,763</b>

### D2.2 Method of valuation

The methodology for the calculation of technical provisions is outlined in the Delegated Act and associated guidelines. In broad terms, the gross technical provisions can be defined as the sum of the best estimate and risk margin.

#### D2.2.1 *Calculation of best estimate*

The best estimate is the total of the discounted policy cash-flows. The policy cash-flows allowed for within the cash-flow projection are:

income	premiums
expenditure	expenses plus surrender, death, disability and maturity benefits (including future bonus declarations where applicable) and tax (if applicable)

The expected cash-flows are generated using product details, individual policy data and assumptions on future expenses and mortality, morbidity and surrender rates.

The surrender values up to 30 April 2020 are based on the surrender value factors set out in the 2019 Surrender Report dated 2 May 2019 and the surrender values from 1 May 2020 are set out in the 2020 Surrender Report dated 19 February 2020.

The cash-flows also include a 'cost of guarantee' to allow for the value of the guarantees, given that actual returns may not be equal to those assumed in the valuation. We consider the effect on both assets backing the liabilities and the guaranteed liabilities themselves, based on volatility assumptions for each asset type. For the cost of guarantee calculation, the guaranteed liabilities are assumed to include a proportion of future reversionary bonus, as e.g. asset value falls could occur after those bonuses have been declared and therefore guaranteed. We use a Black-Scholes formula method.

#### D2.2.2 *Calculation of risk margin*

The risk margin is a part of the technical provisions required to ensure that the value of technical provisions is equivalent to the amount that an insurance undertaking would expect to require in order to take over and meet the insurance obligations.

The risk margin is calculated as the cost of providing an amount necessary to support the insurance obligations up until their maturity or final claim date. Under the Delegated Act, the amount required is equal to the Solvency Capital Requirement ("SCR") for the insurance obligations. The cost of providing this amount is calculated as the cost of capital rate multiplied by the SCR at each time interval in the future up until the policy end date and discounted back to the valuation date. The cost of capital rate within the Delegated Act is 6%.

For the calculation of the risk margin, Article 38 of the Delegated Act states that the risk margin calculation should assume that the assets are selected in such a way that they minimise the Solvency Capital Requirement for market risk. Therefore, it has been assumed that the Society would be able to rebalance its asset portfolio in order to minimise the market risk SCR down to zero. This is a consequence of the Society's policy liabilities being held within a With-Profits Fund, which allows such rebalancing to take place. A similar argument applies for the counterparty risk. The calculation of the risk margin therefore only includes life underwriting and operational risk.

### D2.2.3 *Unbundling*

Unbundling refers to the requirements to separate, where possible, different lines of business that are included within one contract. The Society's death and disability policies include elements of health insurance (with profit participation) and life insurance (with profit participation), but it would be difficult to define obligations and premiums attributable to each part, so the two lines of business have not been separated and all business is assumed to be life insurance with profit participation.

### D2.2.4 *Contract Boundaries*

Article 18 of the Delegated Act provides principles to follow when determining the contract boundary of a policy type i.e. the future point at which the calculation of future net cash-flows should cease. As the Society has fixed premium rates throughout the term of its policies, the contract boundary is the maturity date for all the Society's policies.

## D2.3 *Assumptions*

The assumptions used are supposed to reflect a reasonable best estimate of the likely experience, with no prudence margins.

### D2.3.1 *Expenses*

We have assumed an expense allowance of 16.3% of premiums. This is consistent with the Society's expected future expenses over the next ten years.

### D2.3.2 *Mortality and morbidity*

The table below summarises the mortality and morbidity assumptions.

	mortality	morbidity
under 17	25% ELT15	
17 or over	40% AMC00/AFC00 ultimate	40% of the Society's own table of disablement rates

### D2.3.3 *Future bonuses*

We have assumed the following pattern of bonuses:

reversionary bonus rate as % pa of sum assured	2019	2020	2021	Thereafter
policies issued on or before 13/3/1984	1.00	0.50	0.00	0.00
policies issued 14/3/1984 to 31/12/2017	0.50	0.25	0.00	0.00
policies issued after 31/12/2017 <sup>(1)</sup>	0.75	0.50	0.25	0.00

(1) In practice, a small number of members applied for policies in November and December 2017 but their policies were not issued until January and February 2018. These policies received sums assured under the old rates and therefore will receive bonuses on the relevant bonus scales.

1 January 2020 to 30 April 2020	
inception year	final bonus rate
1974-1976	2.00%
1977-1985	0.00%
1986-1990	13.50%
1991-1993	11.50%
1994-2002	9.50%
2003-2007	8.00%
2008-2009	1.50%
2010-2019	0.50%

1 May 2020 to 30 April 2021	
inception year	final bonus rate
1974-1975	4.25%
1976-1983	0.25%
1984-1986	14.75%
1987-1992	16.75%
1993-1999	16.25%
2000-2006	12.25%
2007-2009	3.25%
2010-2019	1.25%

The final bonus is assumed to be paid only until April 2021 and could be changed at any time.

### D2.3.4 *Surrenders*

We assume that lapses occur at the following rates per annum in the table below. The surrender value is calculated as the premiums paid multiplied by the current surrender factor.

Duration in force (years)	Age		
	0-14, 40+	15-19, 30-39	20-29
less than 1	2.25%	3.00%	3.50%
1-2	10.25%	13.50%	15.75%
3	7.00%	9.00%	10.50%
4-8	5.50%	7.25%	8.50%
9-14	3.00%	4.00%	4.50%
15-19	2.25%	2.75%	3.25%
20+	3.25%	4.00%	4.75%

## **D2.5 Level of uncertainty**

There are no material deficiencies in the data used for the calculation of the technical provisions.

By definition, the models used in the calculation of the technical provisions are a simplified version of real life but are designed to capture the key features of the cashflows being modelled. The Society is not aware of any material features that have been excluded from the calculations and the methodology employed is proportionate to the nature, scale and complexity of the risk accepted by the Society.

The cashflows projected in determining the technical provisions are best estimates. However, there is always uncertainty in projecting those cashflows, including uncertainty of timing, frequency of and severity of claim events, uncertainty in claim amounts, uncertainty in expenses and uncertainty in policyholder behaviour.

A robust assumption setting process is followed to ensure that uncertainties are well understood. Historical experience is used to guide the assumption setting, but past experience is no guarantee of future experience. Analysis of how the model results compare to past experience can be used as a guide and is part of the assumption setting process. The sensitivity of the results is also central to the assumption setting process. The technical provisions are most sensitive to discount rates, lapse and expense assumptions.

## **D2.6 Explanation of material differences between Financial Statements and Solvency II**

The technical provisions shown in the Society's Financial Statements are equal to the Solvency II technical provisions, therefore there are no differences in the bases, methods and assumptions used.

## **D2.7 Transitional adjustments**

The regulations allow insurers, in some circumstances, to use transitional adjustments to smooth the change between the Solvency I and Solvency II regimes. The Society has not used any of the following:

- the matching adjustment referred to in Article 77b of the Directive
- the volatility adjustment referred to in Article 77d of the Directive
- the transitional risk-free interest rate-term structure referred to Article 308c of the Directive
- the transitional deduction referred to in Article 308d of the Directive.

The Society has used the equity transitional measure referred to in Article 308b(12) of the Directive.

## **D2.8 Recoverables from reinsurance and Special Purpose Vehicles**

The Society does not have any reinsurance or use any Special Purpose Vehicles.

## D2.9 Material changes in assumptions and methods from previous reporting period

The material changes in assumptions between 31 December 2018 and 31 December 2019 were:

Assumption	Change and Reason	Effect £000
Surrender values	Changed, based on updated asset shares	(141)
Expenses	Lower proportion of premium, due to expectations of significantly higher new business without significantly higher expenses. Allowance for investment management fees.	(98)

## D3 Valuation of other liabilities

The table below details the valuation of other liabilities for Solvency II purposes and as per the Financial Statements, which follow UK GAAP.

£000	Solvency II	Financial Statements
claims outstanding	171	171
other creditors	302	302
total other liabilities	473	473

### D3.1 Recognition and Valuation Basis

There has been no change to the recognition or valuation basis of other liabilities for Solvency II purposes during the reporting period.

## D4 Alternative methods for valuation

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

## D5 Other material information

No other material information is necessary to give a full picture of the Society's valuation for solvency purposes.

## **E Capital Management**

### **E1 Own funds**

The Society is a mutual organisation and so does not have any shareholders. The Society's own funds are essentially the surplus accumulated that has not yet been allocated to policies. It forms the working capital of the Society and is available to meet risk and capital requirements, as well as any uncertain additional liabilities that may arise in the future. It is classified as Tier 1 own funds.

£000	31 December 2019	31 December 2018
total basic own funds	8,897	6,692

There has been a significant increase in the value of assets over the past year, coupled with a slight increase in the technical provisions. The overall effect has caused an increase in own funds.

All the own funds are eligible to cover the SCR and MCR.

#### **E1.1 Objectives, policies and processes for managing own funds**

The Society has a Risk and Capital Management Policy, which includes a minimum level of free assets (i.e. own funds less capital requirement) that the Society aims to maintain. This is set with the aim of ensuring that the Society can still meet its liabilities and capital requirements in a wide range of future circumstances. The policy also states potential actions to be taken if the free assets reach a specified "trigger point" which is higher than the minimum level, such as realignment of investment portfolios.

The Society's solvency position is monitored regularly:

- Liabilities are revalued at least quarterly, with revaluation more regularly if conditions suggest its free assets may be approaching the trigger point.
- Weekly calculations are normally carried out using the most recently calculated liabilities and estimated assets, based on market movements.
- The estimated solvency position is provided to the Management Committee each month.

The Society also carries out annual projections of its business, focussed on its business planning period of five years, but projecting for at least ten years, and including projections under a variety of scenarios.

#### **E1.2 Comparison of own funds under Solvency II and in Financial Statements**

The Own Funds shown in the Society's Financial Statements are equal to the Solvency II own funds.

#### **E1.3 Other issues**

- None of the basic own funds are subject to the transitional arrangements referred to in Articles 308b(9) and 308b(10) of the Directive.
- There are no ancillary Own Funds.
- No deductions are made from Own Funds as there are no significant restrictions affecting the availability and transferability of Own Funds within the Society.

## E2 SCR and MCR

### E2.1 Overall method for calculating SCR

The Society has adopted the standard formula methodology approach. The methodology for the calculation of capital requirements is outlined in the Delegated Act and associated guidelines.

The SCR is capital that needs to be held in addition to the technical provisions (best estimate plus risk margin). There is no capital add on. The Society does not use any of the standard formula simplifications set out in the Delegated Act for the SCR calculation, nor any undertaking-specific parameters. The SCR is assessed based on the Society's risks as being sufficient to cover possible losses due to those risks. It considers four different risks: market, counterparty, life underwriting and operational.

The capital requirements under each risk module (apart from operational risk) are calculated and then correlated together to form the BSCR. The capital requirements are calculated both before and after the loss absorbency of technical provisions so that an adjustment to the BSCR can be made to allow for the fact that capital requirements will change if future discretionary benefits can be changed. The capital requirement for operational risk is then added on as an additional requirement at the end of the calculation.

In summary the SCR formula is:

- BSCR + Adjustment for Loss Absorbency of Technical Provisions + Operational Risk

The resulting SCR by risk module is shown below. The SCR is still subject to supervisory assessment, but we have not had any queries from the PRA on previous submissions.

### E2.2 Life underwriting risk

£000	before loss absorbency	after loss absorbency
mortality	62	0
longevity	0	0
morbidity	80	0
lapse	130	164
expense	613	0
CAT	40	40
total before correlation	<b>925</b>	<b>204</b>
total after correlation	<b>756</b>	<b>178</b>

### E2.3 Market risk

£000	before loss absorbency	after loss absorbency
interest rate	39	0
equity	3,534	2,563

£000	before loss absorbency	after loss absorbency
property	846	412
currency	1,038	564
spread	1,056	579
concentration	0	0
total before correlation	<b>6,514</b>	<b>4,118</b>
total after correlation	<b>5,425</b>	<b>3,527</b>

The Society does not use the duration-based equity risk sub-module option set out in Article 304 of the Directive.

#### E2.4 Counterparty risk

£000	before loss absorbency	after loss absorbency
counterparty	192	0

#### E2.5 BSCR

	£000
BSCR before loss absorbency	5,717
BSCR after loss absorbency	3,576
Y = BSCR before loss absorbency less BSCR after loss absorbency	2,141
Z = total value of technical provisions in relation to future discretionary benefits	7,932
loss absorbency of technical provisions = maximum(minimum(Y, Z), 0)	<b>2,141</b>

#### E2.6 Operational risk

	£000
premiums earned in prior year	4,456
premiums earned in this year	4,425
technical provisions (without risk margin)	25,739
OP (premiums)	177
OP (technical provisions)	116
SCR operational risk	<b>177</b>

## E2.7 Overall SCR

£000	31 December 2019	31 December 2018
BSCR	5,717	4,859
less loss absorbency of technical provisions	2,141	1,703
plus SCR operational risk	177	178
<b>overall SCR</b>	<b>3,753</b>	<b>3,333</b>

The Capital Requirement has increased principally because of an increase in the market risk component offset partially by a decrease in the life underwriting risk component.

## E2.8 Minimum Capital Requirement

The Minimum Capital Requirement ("MCR") is calculated as  $MCR_{linear}$  (see below), subject to a floor of 25% net SCR and ceiling of 45% of net SCR, but with an overall minimum of €3.7m, i.e.: maximum (€3.7m, minimum (45% net SCR, maximum (25% net SCR,  $MCR_{linear}$ )))

For the Society,  $MCR_{linear}$  is defined as 3.7% of technical provisions for guaranteed benefits less 5.2% of technical provisions for discretionary benefits. The absolute floor of €3.7m converted into pounds using the official exchange rate is £3,187k.

The calculation below shows that the €3.7m absolute floor bites, so the minimum capital requirement is £3,187k, lower than at 31 December 2018 due to a slight gain in the value of sterling relative to the euro. As last year, this is less than the SCR.

£000	31 December 2019	31 December 2018
Solvency Capital Requirement	3,753	3,333
technical provisions - guaranteed benefits	17,622	17,431
technical provisions - discretionary benefits	8,117	7,811
$MCR_{linear}$	248	257
SCR-related floor (25% SCR)	938	833
SCR-related ceiling (45% SCR)	1,689	1,500
absolute floor	3,187	3,288
<b>Minimum Capital Requirement</b>	<b>3,187</b>	<b>3,288</b>

## E3 Non-compliance

The Society has had sufficient assets to cover the technical provisions, MCR and SCR at all times during 2019.

## E4 Other material information

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