We publish our annual Report and Accounts today under terribly sad circumstances, the passing of Scottish Friendly's Chief Executive Officer, Jim Galbraith on the 6th of April 2021.

For over 30 years, Jim has been at the heart of the Society's journey and in that time his passion for our mutual life office had shown no end. Jim had devoted the best part of his career to strengthening, guiding, and driving forward Scottish Friendly.

Being a leader naturally endowed with wisdom, focus, and purpose,
Jim laid the foundations of Scottish Friendly by building an experienced leadership team; dedicated to maintaining his historic vision.
Jim's presence, dry humour and especially his friendship will be sorely missed by everyone.

We are focussing on providing support to our staff, many of whom have known Jim for a significant amount of time whilst planning to ensure the continuity of our business. On that note, The Board has appointed Martin Pringle into the role of acting CEO.

Yours sincerely,

David Huntley, Chair Scottish Friendly

Annual Report & Accounts

2020

A warm welcome

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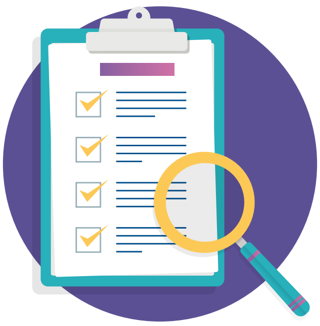

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For more information on Scottish Friendly and its products visit www.scottishfriendly.co.uk

Overview

“In what has been one of the most extraordinary years in recent history I am pleased to report that we have demonstrated our resilience.”

2020 Highlights

Scottish Friendly's status as a mutual means that we are not driven by the needs of shareholders. Instead we are owned by, and run for the benefit of our members and profits are reinvested in the interest of those members.

Scottish Friendly firmly believes that saving and investing should be for everyone, which is why we have a commitment to offer understandable and accessible products, helping to secure a better financial future for individuals and their families.

We are proud to be one of the largest mutual life offices in the UK, with a history reaching back almost 160 years.

Sales (APE) [1]

42.0m

Sales of life protection through partnerships was a key driver of the £42.0 million (2019 - £37.8 million) sales figure total. In total, this represents the second highest sales figures in Scottish Friendly's history and once again, there were record sales across Scottish Friendly's range of branded products.

Number of members

745,000

2020 has seen continued growth in the number of members, from 712,000 to 745,000, supported by the continued success of the partnership and own brand products.

Assets under Management (AuM)[2]

£5.3bn

Assets under management remained steady at £5.3 billion during the year, primarily reflecting market movements alongside operational cashflows such as premiums and claims.

Pillar 1 Capital

162%

The solvency ratio, defined as the ratio of our capital resources to the capital requirements under the applicable Solvency II regulatory regime, remains strong and well above regulatory requirements.

Investment Performance[3]

3.4%

Our mutual status means we do not pay shareholders dividends and ensures that we are focused on delivering value for our members. The return on asset shares within the Scottish Friendly Main With-Profits Fund was 3.4%. This compares to the FTSE All Share Total Return Index performance decrease of (9.8%) and the FTSE Actuaries UK Conventional Gilts All Stocks Total Return Index increase of 8.3% over the year.

[1] Annual Premium Equivalent, gross of reinsurance (APE = Annual Premium Equivalent, calculated as the annual amount of regular premiums plus one tenth of the single premiums on business written during the year).

[2] Assets under management include assets in the Scottish Friendly Investment Funds ICVC.

[3] Scottish Friendly's investment performance is further increased by enhancements to with-profits policies in respect of the Special Members' Share of 1.2%. This takes the total return for those policies to 4.6%

Chair's Statement

"Our priority throughout has been, and will continue to be, the health and wellbeing of our colleagues, our members and the wider community."

Covid-19

This year's report and accounts are being published on the back of an unparalleled year, with Covid-19 casting its shadow over society, our members and colleagues. Every household across the UK has been affected in one way or another during these challenging times and, although it looks as though we are beginning to see the light at the end of the tunnel, with the rollout of a number of successful vaccines, it is inevitable that the social and economic scarring of this virus will be with us for several years to come.

Our priority throughout has been, and will continue to be, the health and wellbeing of our colleagues, our members and the wider community. However, I am pleased to report that, notwithstanding the challenges presented by this global pandemic, we have not only continued to deliver services to our customers but have also managed to retain a focus on development, innovation and growth.

Despite the difficulties experienced during 2020, not least in adapting our service to the changing demands of customers and colleagues working from home, Scottish Friendly remains steadfast to our vision and core purpose which is to help support and protect families, especially through such periods of uncertainty.

Strategy

Writing this opening statement for the first time in my role as Chair, and despite the continuing challenges we face, I am pleased to announce we have achieved our second highest set of sales in our history.

This underlines the value of our long-term strategy, based on resilience and puts us in a strong position to continue to support our members.

During the course of the year, we did however take the opportunitiy to undertake a comprehensive review of our corporate strategy, engaging both with the Board and a significant number of colleagues from across the business.

Following the review, our defined strategy, from a growth perspective, remains largely unchanged, comprising three main elements within the life and pensions market:

- Organic growth (own brand products and portfolio)
- Partnering (new partners and new offerings to existing partners)
- Mergers and acquisitions

In addition, we have now more clearly articulated an emphasis on increasing digitalisation, automation and continuous process improvement targeted towards enhancing member experiences while, where possible, delivering operating cost synergies.

Our existing strategy, this year, resulted in total sales of £42.0 million APE (2019: £37.8 million APE), the second highest in our 159-year history. Assets under management remained steady, while member numbers increased from 712,000 to 745,000 during the year.

Going forward, our core objective remains unchanged: we are here for everyone, regardless of age, income, or any previous financial experience.

The regulatory environment

Throughout 2020, Scottish Friendly has implemented necessary changes to ensure we continue to meet the various requirements, and expectations, of our regulators the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

How firms responded to the Covid-19 pandemic during the year was a key focus for both the PRA and FCA. The FCA issued various guidance detailing how it expected insurance firms to protect their customers and help those potentially vulnerable customers facing financial difficulties due to the pandemic. Scottish Friendly implemented various measures to meet these expectations and to ensure customers were being appropriately protected.

Strengthening operational resilience remained a key regulatory priority. The Covid-19 pandemic also reinforced the importance of being able to continue to deliver customer services, even during severe operational disruption. Throughout 2020, Scottish Friendly has continued its planning on areas to be strengthened, to ensure we are ready to meet the standards on operational resilience that will be set during 2021.

Governments and regulators, globally, have significantly increased expectations on how firms manage and respond to climate related financial risks. Scottish Friendly has continued to enhance its approach, including the maturing of the scenario approach used in the ORSA and continued embedding of climate change risk in risk management. This work will continue in the year ahead in line with regulatory expectations. Scottish Friendly remains fully committed to engaging with regulatory and industry groups to ensure alignment with emerging industry practice in this important and evolving area.

Finally, throughout 2020, Scottish Friendly continued to prepare for the end of the Brexit transition period, and took appropriate steps to prevent disruption and ensure we continue to serve our customers who live in the EU.

Corporate governance

The strength and flexibility of our governance processes help us to respond to regulatory changes and developments in best practice. The corporate governance structure reflects the importance the Board attaches to its wider responsibilities to customers and members. Specific details are included in the Report on Corporate Governance on pages 24 to 38 of this Annual Report.

Scottish Friendly is a member of the Association of Financial Mutuals and supports its governance standards. This promotes the interests of our members and helps to sustain the value of mutual societies in the UK. Scottish Friendly applies the principles set out in the Code and reports on them in our financial report and accounts. Specific details are included in the Report on Corporate Governance on pages 24 to 38 of this Annual Report.

We are committed to maintaining best practice and to driving the continued improvement of our key processes. This is reflected in being re-awarded the ISO 27001 and ISO 22301 certifications, the International Standards for Information Security and Business Continuity Management respectively.

Corporate social responsibility

The Scottish Friendly Children's Book Tour continues to support Scottish Book Trust in its efforts to improve child literacy.

In March 2020, Covid-19 restrictions resulted in school closures across the UK. We responded immediately by transforming the tour from classrooms into living rooms. Working with some of the UK's leading authors and illustrators, the tour went virtual for the first time, with the development of educational video content published on social media, with the aim of providing supporting materials to children, parents and teachers at a time when they needed it most.

In addition, I am pleased to report that Scottish Friendly was able to continue its support to a number of charities, including Action for Children, The STV Children's Appeal, The Boswell Book Festival and The Prince's Trust.

Corporate recognition

During 2020 Scottish Friendly's performance was once again recognised with the reward of a number of industry accolades, including Best UK Mutual Insurer at the CFI Awards and Best Junior ISA Provider at the Investment Life & Pensions Moneyfacts Awards, both of which were won for the second year in succession. Scottish Friendly was also highly commended for best financial protection provider at the What Mortgage Awards and, through the results of a poll conducted by Savanta, named inside the top 100 most loved UK financial services brands. The achievement of these awards reaffirms the trust we have earned not only from our own customers but the wider financial services industry and business community.

Scottish Friendly significantly increased its UK media profile in 2020, with a 50% increase in the volume of press coverage across national and regional press. This was achieved through a variety of different media, including consumer research, corporate news targeting the business pages of the national press and regular commentary on industry topics affecting everyday lives.

The Scottish Friendly Investor Index was launched in October 2020. This quarterly index monitors the behaviours of Scottish Friendly's ISA customers, highlighting movements in consumer savings patterns.

Scottish Friendly's people

As I said earlier, 2020 was a truly extraordinary year. I would like to take the opportunity to say how proud I am of each and every one of my colleagues across the business. I am impressed at how well they have adapted during this period to new working methods, and environments, whilst attempting to meet the changing demands of customers throughout the pandemic. The safety and wellbeing of our colleagues, our members and their families will always remain a top priority.

I would also like to take this opportunity to thank Michael Walker who retired at the AGM having been Chair since 2009. Michael oversaw transformational growth at Scottish Friendly during this period and steps down with the Group in a strong position. To put it into context, assets under management were £704 million and member numbers 489,000 when Michael assumed the role of Chair which all goes to show just how much we have grown over the past decade.

I am, however, delighted to say that Michael will continue to support us as a Delegate. Once conditions and associated restrictions permit, we will, finally, arrange an appropriate celebration with Michael to acknowledge our thanks and appreciation for his outstanding service and contribution to Scottish Friendly.

On the topic of our delegates, I would like to express my appreciation to each of you for your continued support and to wish you and your families well for the year ahead.

Over the coming years, I am very much looking forward to continuing to work alongside our excellent Chief Executive, Jim Galbraith. Jim's track record speaks for itself and I am delighted to say that in 2020 it came as no surprise to any of us when his efforts and dedication to Scottish Friendly were acknowledged by the Institute of Directors, Scotland, with the award of Director of the Year. A fantastic achievement and whilst Jim is too modest to say so, it is very well deserved.

For now, I look forward to my first full year as Chair and, in particular, to playing my part together with the rest of the Board in ensuring Scottish Friendly remains focussed on its vision and purpose while delivering on its agreed business plan. Whilst Covid-19 will clearly continue to play a significant part in our thinking, it will not stop our drive to innovate, grow and, above all, do our best to serve the needs of all our members.

D Huntley
Chair
31 March 2021

"Going forward, our core objective remains unchanged: we are here for everyone, regardless of age, income, or any previous financial experience."

Chief Executive's Review

"We remain well placed to come out of the pandemic stronger than we entered it, enabling us to continue to achieve our vision to provide long-term sustainable growth in value for our members."

Strategy

Scottish Friendly started the year with a clear strategy in place. Little did anyone in the UK know just how quickly the pandemic was going to sweep across the country and how profound the impact would become. We had to respond and we had to do so at pace to ensure we continued to serve the needs of our customers and protect the health of our colleagues.

Within two weeks the majority of our colleagues were working securely from home, with only those undertaking important tasks that were impossible to do from home remaining in the office. Our IT department did a remarkable job to ensure that everyone had the IT infrastructure to work effectively from home and we have also provided office equipment to our staff to ensure they can work safely and securely at home. We continue to invest in our technology to improve working from home with all colleagues now using Virtual Desktop Infrastructure (VDI).

With the increased risks associated with the pandemic we have increased investment in cyber security and developed and strengthened our Risk Management Framework, helping to further build our capabilities and strength for the future.

While our colleagues adapted swiftly to a new way of working, Scottish Friendly created an entirely new HR function, further supporting colleague wellbeing with the development of a number of initiatives including HR drop-in sessions and online fitness classes as well as developing new ways of communicating professionally and socially. In addition, a working group made up of volunteers from the business developed a set of company values. I am proud to say that rather than standing still, Scottish Friendly has also continued to grow, recruiting in key areas to help support us through the impact of Covid-19, in particular our customer service and contact centre functions.

Adapting to the effects of the lockdown required a considerable investment in people and processes, all of which took time. There is no doubt that, as a result of escalating demands from customers, combined with new ways of working, our service levels suffered at the start of lockdown. However, after further investment and process efficiencies, we were able to bring service levels back within our targeted levels.

Scottish Friendly will continue to improve the products and services we offer our customers. We pride ourselves on differentiating through innovation, efficient customer services and responsible capital management and this is no different whether we are working from home or in the office.

In spite of the current challenges we face across the UK, we remain well placed to come out of the pandemic stronger than we entered it, enabling us to continue to achieve our vision to provide long-term sustainable growth in value for our members.

Scottish Friendly's Strategy

Organic growth

Responding to the demands of Covid-19 and changes to the way many of our customers wanted to interact with us, we immediately adapted our targeted marketing activity by seeking out alternative distribution channels delivered into the home. In addition, we adapted our key messages, focusing on certainty and peace of mind through these unpredictable times.

Scottish Friendly's e-business and direct marketing activity achieved another year of strong sales growth despite increased economic uncertainty, resulting in a 13% increase in own brand revenue to over £15 million APE. Targeting more individuals through our mobile app resulted in a fifth of Scottish Friendly branded sales coming through this channel and as we continue on our journey of becoming an app-first financial services.

Paper-based marketing activity was reduced throughout the course of 2020, helping to reduce our carbon footprint. In addition, Scottish Friendly increased marketing activity across social media through Facebook adverts and developed a successful radio campaign in the second half of the year. The latter is important as it offers another scalable way for us to develop our business reach and we expect to develop this alongside our app based activity over the next 12 months.

Partnership business process outsourcing

Scottish Friendly continues to work with a wide range of corporate partnerships, contributing strongly to the Group's overall results in 2020.

While some partners suffered due to the nature of lockdown limiting face to face interaction with customers, Scottish Friendly continued to restructure our relationships and support them through this difficult period. Term assurance partners performed strongly through this period as more individuals and families looked to protect themselves.

Scottish Friendly continued to restructure and deepen our relationships with Beagle Street and Guardian Financial Services.

In addition, we launched a new over 50's plan through a new brand of Neilson Financial Services, called Zestylife Insurance.

Our strategy to diversify through a range of corporate partners continues to prove successful, smoothing out extreme market conditions like we have experienced throughout 2020. We are confident our investment in innovative products, technology and customer service will continue to add value to our existing partners while we seek to attract new ones.

Mergers and consolidation

The focus in 2020 was to further embed the Canada Life book of life and pensions business purchased in November 2019. This was the largest acquisition in our history, significantly increasing assets under management and member numbers, and involved the transfer of a number of new products to administer.

We continue to have a long and proven track record of acquiring and administering large books of insurance businesses and will continue to look for appropriate mergers and acquisition opportunities in the future.

Results

Scottish Friendly delivered the second strongest set of results in its history despite significant market volatility. Total sales were £42.0 million APE.

The corresponding figure in 2019 was £37.8 million. Of the 2020 total, protection sales were £24.1 million (2019: £19.5 million) and savings and investments, which includes Scottish Friendly own brand, whole of life and savings partners, amounted to £17.9 million (2019: £18.3 million). Included within savings and investments, Scottish Friendly own brand sales increased in 2020 to £15.7 million

(2019: £13.5 million).

Earned premiums increased to £146.2 million (2019: £125.5 million). Net premium income (after reinsurance) from insurance contracts increased to £84.4 million (2019: £73.8 million). The ratio of administration expenses to total premium income APE decreased to 8.4% (2019: 8.5%).

The Net Transfer to the Fund for Future Appropriations for the year was £12.7 million (2019: £6.2 million).

Scottish Friendly membership increased from 712,000 in 2019 to 745,000 in 2020. Scottish Friendly administers more than one million policies across more than 350 product lines.

Scottish Friendly remains strongly capitalised. Our capital ratio, in spite of the turbulence in financial markets, ended at 162% (2019: 169%), remaining, at all times, well above regulatory requirements.

Financial position

The return attributed to the asset shares within the Scottish Friendly Main With-Profits Fund for 2020 was 3.4%, against 12.0% in 2019. Scottish Friendly's investment performance is further increased by enhancements to with-profits policies in respect of the Special Members Share of 1.2%, taking the total return to 4.6%. This performance reflects a year of significant volatility across financial markets, which saw the FTSE All Share Index decrease by 9.8% and the FTSE Actuaries Government Securities All Stocks Total Return index increase by 8.3%. The performance of the fund supports the current and future ability to pay bonuses to our With-Profits policyholders. Scottish Friendly assets under management remained steady at £5.3 billion during the year, reflecting market movements and the run-off of the acquired business.

In spite of the market volatility and considerable challenges throughout the year, our capital position as measured by the solvency coverage ratio remains strong at the year end date and, at 162% (2019: 169%), was significantly in excess of the regulatory requirements under the Solvency II regulatory regime that applies to insurers. The small fall over the year reflects the effect of market movements, including the impact from declines in interest rates.

This strength of the capital position means that although the Covid-19 outbreak, and the associated significant global economic disruption, has impacted the capital ratio of the business since the end of 2019, Scottish Friendly remains well capitalised. The solvency position is monitored frequently, and appropriate actions are taken to protect the long-term interest of policyholders and the overall capital position of Scottish Friendly.

Scottish Friendly's Fund for Future Appropriations is £204 million at the year end with a surplus of £13 million being generated in the year. The Fund for Future Appropriations represents funds that have not been allocated to specific policyholders and free assets.

ESG

We continue to look to develop our Environmental, Social and Governance (ESG) framework with the focus on ensuring sound corporate governance, investing responsibly and ensuring that we have appropriate policies and metrics to support our policyholders and staff.

Investment Strategy

Scottish Friendly aims to invest its funds in a responsible manner and has an approved ESG Policy for investments which is monitored by the Investment Committee. Over the past year, we have continued to develop capabilities in this area working with investment managers and will continue to do so going forward. In addition, Scottish Friendly launched its first Ethical Fund in 2020, adapting to the demands of our customers.

The Investment Strategy is set based on due consideration of the long-term interests and expectations of the different groups of policyholders and sub-funds, within the context of the solvency position and risk appetite of Scottish Friendly. The performance of the strategy is reviewed regularly, with changes made, where appropriate, to reflect changes in the business or market environment.

The Board

2020 has been a time of planned change in the Board at Scottish Friendly.

Michael Walker, who has been our Chair since January 2009, retired as a Director in May 2020. I would like to reiterate the Board's sincere thanks to him for his contribution, and my personal thanks for all of his support, and I am delighted that he continues as a Delegate.

I am also very pleased to advise that David Huntley has been appointed as Chair, and I look forward to working with him in that role.

September 2020 saw the arrival of Susan Beckett as a Non-Executive Director. Susan assumed the role of Chair of the Risk Committee and is already making a valuable contribution to the Board.

Outlook

Covid-19 has gone on longer than anyone would have hoped or foreseen and will continue to be a dominant factor for the immediate future. Scottish Friendly will continue to serve our members despite these uncertainties.

Scottish Friendly continues to take strength from its mutual status. We have experienced many economic cycles and have always taken the long-term view, enabling us to protect value during short term turbulence while planning measures to enhance our asset base in the future. Our 2020 financial results yet again demonstrate our agility, flexibility, and our commitment to be resilient through these difficult times.

We recognise the challenges that lie ahead and our key focus remains on the health and wellbeing of our colleagues, of whom I am immensely proud. I extend my thanks to each and every one, who together are working hard for the benefit of our members. Whilst the immediate future remains uncertain, we continue to remain confident in our ability to meet its challenges.

J Galbraith
Chief Executive
31 March 2021

Governance

Scottish Friendly continues to embrace best practice in corporate governance and is committed to the principles of the AFM Corporate Governance Code for Mutual Insurers

Directors

David C Huntley BA, FIA

Chair (from 28 May 2020)

Appointed as a Director in January 2013. Chair of the Nomination Committee and member of the Remuneration Committee, Investment Committee and Risk Committee. Chair of the Scottish Friendly Assurance subsidiary companies: Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM Assurance (Trustees) Limited and SF Pension Managers & Trustees Limited. Chair of FIL Life Insurance Limited and Non-Executive Director of FIL Life Insurance (Ireland) DAC and Hampden & Co plc. Former Managing Director of Pearl Life Division and CEO of Swiss Re Life and Health Australia.

Dermot J Jenkinson

Vice-Chair and Senior Independent Director

Appointed as a Director in November 2011. Chair of the Remuneration Committee and member of the Audit Committee and Nomination Committee. Appointed Vice-Chair and Senior Independent Director in April 2015. Over 30 years' commercial executive and non-executive experience in developing and managing a wide range of businesses in the UK, USA and EU, covering services, distribution, corporate finance and advice. Scottish Entrepreneur of the Year 2009. Executive Chairman of Ascensos Limited and other private companies.

Kerr Luscombe BSc, FFA

Appointed as a Director in June 2015. Chair of the Audit Committee and member of the Risk Committee, Remuneration Committee and With-Profits Committee. Director of the Scottish Friendly Assurance subsidiary companies: Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM Assurance (Trustees) Limited and SF Pension Managers & Trustees Limited. Fellow of the Institute and Faculty of Actuaries with extensive experience at Board level in the life insurance industry. Previously a Director of Royal London Group and also held finance Directorships at both Lloyds Banking Group and Santander's life insurance businesses. Currently an Independent Member of the With-Profits Committee at Aegon UK and Chairman of the With-Profits Committees at Phoenix Group and Standard Life.

Directors (cont)

Anja M Balfour BSc (Hons), ASIP

Appointed as a Director in April 2018. Chair of the Investment Committee and member of the Risk Committee and With-Profits Committee. Currently Chair of Schroder Japan Growth Fund plc and BMO Global Smaller Companies Plc and Non-Executive Director of AVI Global Trust plc.

Gillian Watson

Appointed as a Director in April 2018. Member of the Audit Committee and Remuneration Committee. Currently Senior Managing Director and Head of Energy & Renewables at Noble & Co, and Chair of DC25 Ltd. Also holds Non-Executive Director positions in Meallmore Ltd, Martin Currie Global Portfolio Trust, Stratera Energy Ltd and Royal Edinburgh Military Tattoo and is a Trustee of the Boswell Trust.

Susan Beckett BSc

Appointed as a Director in September 2020. Chair of Risk Committee and member of the Audit Committee. Chief Risk Officer (SMF4) for Brewin Dolphin, joining the firm in 2014 having held similar senior leadership positions at global firms including Schroders, JP Morgan, Barclays Global Investors, BlackRock, Kleinwort Benson, and the BT Pension Scheme. Non-Executive Director and Chair of the Board Risk Committee for Brewin Dolphin Wealth Management, Dublin. Appointed as Director of Scottish Friendly Asset Managers Limited in September 2020.

Jim Galbraith BSc, MBA, FFA

Chief Executive

Appointed as a Director in April 2006. A qualified actuary with over 30 years' experience in the life insurance industry. Joined Scottish Friendly in 1988. Member of the Nomination Committee, Investment Committee and Risk Committee. Director of the Scottish Friendly Assurance subsidiary companies: Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM Assurance (Trustees) Limited and SF Pension Managers & Trustees Limited. Trustee of the MGM Assurance Staff Pension Plan.

Neil E Lovatt BA (Hons), MSc (Dip), ACII

Commercial Director

Appointed as a Director in January 2017. A marketing and product design professional with nearly 30 years' experience in the life, pensions and investments industry, including senior positions at Scottish Life and Royal London. Joined Scottish Friendly in June 2006.

Martin Pringle BSc, FCA

Finance Director and Company Secretary

Joined Scottish Friendly in June 2016. Appointed as a Director in February 2018. A qualified chartered accountant with over 20 years' experience in the financial services industry. Member of the Investment Committee and Board. Secretary for the Board, Board Committees and the subsidiary companies. Appointed as a Director of Scottish Friendly Asset Managers Limited in January 2021.

Executive

J Galbraith BSc, MBA, FFA
Chief Executive

NE Lovatt BA (Hons), MSc (Dip), ACII
Commercial Director

M Pringle BSc, FCA
Finance Director and Company Secretary

A Abernethy BSc, MSci
Head of Risk Assurance and Compliance

G Humphreys BSc, FFA, CERA
Chief Risk Officer

J Mackay BA (Hons)
Head of Marketing

S Macpherson BSc (Hons)
Head of IT

I Neilson
Operations Director

A Rankine BSc, FFA
Head of Actuarial

P Simmons BA, FCIPD
Head of HR (joined 2 March 2020)

Directors' Report

The Directors have pleasure in submitting their Annual Report and Accounts for the year ended 31 December 2020. This report should be read in conjunction with the Strategic Report on pages 7 to 15.

Business objectives and activities

The principal activity of Scottish Friendly Assurance Society Limited ("Scottish Friendly") is the transaction of long-term insurance business in the United Kingdom. In accordance with the Friendly Societies Act 1992, the Directors confirm that all activities carried on during the year by Scottish Friendly are believed to have been within its powers.

Scottish Friendly is authorised by the Prudential Regulatory Authority and regulated by the Financial Conduct Authority and the Prudential Regulatory Authority. It has six wholly owned subsidiaries, (collectively with Scottish Friendly "the Group"): Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM Assurance (Trustees) Limited and SF Pension Managers & Trustees Limited. Scottish Friendly Asset Managers Limited is authorised and regulated by the Financial Conduct Authority and conducts the business of managers for transactions in Scottish Friendly ISAs, Junior ISAs and Child Trust Funds. The principal activity of Scottish Friendly Insurance Services Limited is the provision of administration services and it is authorised and regulated by the Financial Conduct Authority. S.L. Insurance Services Limited conducts the business of agents for the transaction of general branch insurance. SFIS (Nominees) Limited is currently dormant. MGM Assurance (Trustees) Limited and SF Pension Managers & Trustees Limited are the trustee entities for the oversight of certain closed pensions schemes.

Scottish Friendly Investment Funds ICVC, an OEIC (Open Ended Investment Company), provides the stocks and shares component of the Scottish Friendly ISA and Child Trust Fund.

All of the above are registered in Scotland, other than MGM Assurance (Trustees) Limited and SF Pension Managers & Trustees Limited which are registered in England and Wales.

Business review

In 2021, a Board effectiveness review will be completed to confirm we are operating in the most efficient way. A review of the performance of the business during the year and the future outlook, including key performance indicators, is included in the Strategic Report on pages 7 to 15.

Directors and Chief Executive

The current Directors of Scottish Friendly, including the Chief Executive, are listed on pages 17 to 19.

Further information on the Board is set out in the Report on Corporate Governance on pages 24 to 38.

Statement of solvency

In the opinion of Scottish Friendly's Head of Actuarial and the Board, Scottish Friendly had the required margin of solvency as prescribed in the Solvency II regulatory requirements as at 31 December 2020 and throughout the year.

Going concern basis

The Board is satisfied that it is appropriate for Scottish Friendly to draw up financial statements on the going concern basis. The Board considers that Scottish Friendly has adequate resources to continue in business for the foreseeable future. In making this assessment, the Board has considered the above statement of solvency from the Head of Actuarial, which is further supported by actuarial valuation and solvency reporting made to the Board on a regular basis, including the Own Risk and Solvency Assessment (ORSA). It is also noted that the Group maintains substantial cash reserves to cover anticipated policy outflows and further contingency is available in that the majority of the investments on both balance sheets are held in readily realisable unit funds.

Against this background, the Board has also considered the ongoing impact of Covid-19, on the business over the going concern period. During this period, the Board has assessed the fact that the Group will continue to need to adjust its client service and operational capability as events unfold in the period ahead, considered and monitored the impact on the capital ratio of the business of the movements in markets, and is satisfied that the business will continue to operate for the foreseeable future.

Longer term viability statement

Scottish Friendly invests for long term capital growth and as such members rely on the stability of the Group over the longer term. This is reflected in the analysis of the principal risks within the Corporate Governance section of this report. Key risks have been analysed and disclosed, as well as the framework in place to manage and mitigate these risks. The sensitivity of the capital position to these principal risks has also been illustrated.

The Risk Management Framework is integrated within the solvency and capital management activity, in particular the ORSA. The ORSA requires Scottish Friendly to consider the risks arising from the agreed strategic priorities, how much capital is needed to protect the business against those risks over the business planning period in the context of the agreed risk appetite, and how resilient the Scottish Friendly business model is under stressed conditions.

This analysis involves testing a number of projections of the capital position under a range of severe but plausible adverse scenarios covering a period of five years, which are relevant in the context of enabling Scottish Friendly to assess the ongoing impact of Covid-19 on the business. This enables management to take any necessary actions to manage risks and ensure the adequate level of capital is held, in line with Scottish Friendly's risk appetite.

Overall, this allows the Board to make an assessment of Scottish Friendly's viability to continue operations and meet its obligations over a five year time period. This period reflects the Scottish Friendly planning cycle. The Board has also considered the ongoing impact of Covid-19, on the business and its day to day operations.

In this environment, the Board has recognised that the Group will need to continue to adjust its client service and operational capabilities as events unfold in the period ahead, and continue to deliver core services from the home environment, and executing plans to minimise the risk of transmission of the virus within the Group's office space.

The robust capital position and the Group's business model means that, although the Covid-19 pandemic has impacted the capital ratio of the business, Scottish Friendly remains well capitalised. Scottish Friendly has considered the impact the virus is likely to have on the continuing operations, in particular the impact on the solvency and operational resilience of the business, and deems that Scottish Friendly has a reasonable expectation it will be able to continue its operations.

Based on the robust assessment of the principal risks, the Directors have a reasonable expectation that Scottish Friendly will be able to continue in operation and meet its liabilities as they fall due over that five year period.

Tax strategy

Oversight of the operation of tax risk has been delegated to the Finance Director. Scottish Friendly has published its tax strategy on its website and this can be found at: https://www.scottishfriendly.co.uk/tax-strategy

Colleagues

For over 150 years we have been here for everyone; that means our people too. Our colleagues come from all walks of life and experiences and we like it that way. We recruit and reward individuals based on their skills, performance and potential — regardless of race, gender, sexual orientation, gender identity or expression, lifestyle, age, educational background, nationality, religion or physical ability. We have a newly established HR function, which encourages and supports conversations and communication to be local, between managers and their teams. We, however reinforce this with a network of people ambassadors and regular colleague surveys which are independently chaired and managed by our Head of HR and communicated to our Executive.

Modern Slavery Act

The Modern Slavery Act 2015 (Slavery Act) requires a commercial organisation over a certain size to publish a slavery and human trafficking statement for each financial year. This statement can be found on Scottish Friendly's website. Scottish Friendly welcomes the act and is committed to the eradication of human trafficking and slavery. Slavery and human trafficking are abuses of a person's freedom and rights. We are totally opposed to such abuses in our direct operations, our indirect operations and our supply chain as a whole. We consider that the greatest risk of slavery and human trafficking would be in our supply chain, where operational and managerial oversight is out of our direct control and we expect our partners to operate in line with our corporate values.

Policy on complaints by customers

Scottish Friendly's complaints procedures, detailing the action to be taken in the event of a complaint being received from a member, are documented in Scottish Friendly's Memorandum and Rules, Complaints Manual and Compliance Manual. There is provision for an arbiter to be appointed. In the event that Scottish Friendly is unable to resolve a complaint to the member's satisfaction, the member is made aware of the option to refer to the Financial Ombudsman Service.

Policyholders and members

As at 31 December 2020, Scottish Friendly had 1,399,000 (2019: 1,388,000) policies and estimated the number of members to be 745,000 (2019: 712,000).

Post balance sheet events

The Directors do not consider there to be any post balance sheet events that need to be disclosed.

Disclosure of information to auditors

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are aware, there is no relevant audit information of which Scottish Friendly's auditors are unaware, and each Director has taken all the steps he or she ought to have taken as a Director to make himself or herself aware of any relevant audit information and to establish that Scottish Friendly's auditors are aware of that information.

Statement of Directors' responsibilities in respect of the Directors' Report and the accounts

The Directors are responsible for preparing the Strategic Report, the Directors' Report, the Report on Corporate Governance and the accounts in accordance with applicable law and regulations.

Friendly Society law requires the Directors to prepare accounts for each financial year. Under that law, they have elected to prepare the accounts in accordance with United Kingdom Accounting Standards and applicable law (United Kingdom Generally Accepted Accounting Practice).

The accounts are required by law to give a true and fair view of the state of affairs of the Group and of Scottish Friendly as at the end of the financial year, and of the income and expenditure of the Group and of Scottish Friendly, for the financial year.

In preparing these accounts, the Directors are required to:

(a) select suitable accounting policies and then apply them consistently;

(b) make judgements and estimates that are reasonable and prudent;

(c) state whether applicable United Kingdom Accounting Standards have been followed, subject to any material departures disclosed and explained in the accounts; and

(d) prepare the accounts on the going concern basis unless it is inappropriate to presume that the Group and Scottish Friendly will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and of Scottish Friendly and enable them to ensure that the accounts comply with the Friendly Societies Act 1992 and the regulations made under it.

The Directors are also responsible for preparing a Directors' Report in accordance with the Friendly Societies Act 1992 and the regulations made under it.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on Scottish Friendly's website. Legislation in the United Kingdom governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.

The Board confirms that, in its view, it has complied with the above requirements in preparing the Report and Accounts and that it considers the Report and Accounts, taken as a whole, are fair, balanced and understandable.

Auditors

In accordance with Scottish Friendly's Rules, Deloitte LLP offer themselves for annual re-appointment at the forthcoming Annual General Meeting.

The Strategic Report and Directors' Report are approved by order of the Directors.

M Pringle
Finance Director and Company Secretary
31 March 2021

Report on Corporate Governance

As a mutual organisation, Scottish Friendly is committed to maintaining accountability to its members. All members are represented by elected Delegates and the Board meets with the Delegates at least twice a year. In addition, members can raise matters directly via the Member Relations function.

As a further part of that commitment to accountability, Scottish Friendly continues to embrace best practice in corporate governance and is committed to the principles of the AFM Corporate Governance Code for Mutual Insurers ("the Code").

In line with the principle of 'apply and explain' set out in the Code, this report describes Scottish Friendly's compliance throughout the period with the principles and provisions of the Code.

The Directors consider that, throughout the period under review, Scottish Friendly has applied the relevant principles and complied with the relevant provisions of the Code as amplified by guidance published by the Association of Financial Mutuals (AFM) in response to the Code.

The AFM asks members to demonstrate in their annual reports how they applied the Code's six high level principles and how that has contributed to better corporate governance. These are detailed below:

AFM Corporate Governance Code Principles	How Scottish Friendly applies to the Principles
Principle One - Purpose and Leadership *"An effective Board promotes the purpose of an organisation, and ensures its values, strategy and culture align with that purpose."*	•A robust Strategic Plan and Business Plan is developed each year, with review by the Executive and Board as part of the Business Planning Away Day. •The My Voice survey, which was implemented in 2019, continued to show positive results. Throughout 2020 of those responding to our staff survey, over 80% of staff answered that they are "proud to work for Scottish Friendly". •Staff focus groups are also held to consider areas of development within the business and the outcome of these discussions are taken forward by HR and the Executive team.
Principle Two - Board Composition *"Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual Directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the organisation."*	•The Nomination Committee evaluates the skills, knowledge and expertise demonstrated by Board members and, where applicable, a proposed role description and capabilities for appointment would be drafted for any new appointments. •The Nomination Committee considers succession planning of key individuals on an annual basis. •All Directors receive a detailed induction and regularly update their skills and knowledge and there is an annual review and evaluation.

AFM Corporate Governance Code Principles	How Scottish Friendly applies to the Principles
Principle Three - Director Responsibilities *"The board and individual Directors should have a clear understanding of their accountability and responsibilities. The board's policies and procedures should support effective decision-making and independent challenge."*	•The Memorandum and Rules set out the policies and practices which apply to Scottish Friendly, in accordance with the Friendly Societies Act 1992. •There are a number of corporate governance documents which are reviewed annually, including the management responsibilities map and manual, conflicts of interest policy, Board and Committee terms of reference and Board Diversity policy. •A suite of management information is provided to the Board on a monthly basis.
Principle Four - Opportunity and Risk *"A board should promote the long-term sustainable success of the organisation by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks."*	•Scottish Friendly has established a framework of internal controls for the management of risk within its business and to safeguard the interests of its members. The system is designed to manage the risk of failure to achieve business objectives, and to provide reasonable assurance against material mis-statement or loss. •A strategic plan detailing how the organisation creates and preserves value over the next five years is prepared annually and approved by the Board. This, along with the Business Plan and ORSA, details how opportunities are assessed in line with our long-term strategy and risk appetite.
Principle Five – Remuneration *"A board should promote executive remuneration structures aligned to the long-term sustainable success of an organisation, taking into account pay and conditions elsewhere in the organisation."*	•Our Remuneration Committee defines our remuneration strategy and ensures that it is aligned to the sustainable success of the business.
Principle Six - Stakeholder Relationships and Engagement *"Directors should foster effective stakeholder relationships aligned to the organisation's purpose. The board is responsible for overseeing meaningful engagement with stakeholders, including the workforce, and having regard to their views when taking decisions."*	•Engagement with stakeholders is undertaken through a variety of mechanisms for example, staff engagement surveys, focus groups, dedicated partnership liaison team and outsourcing services meetings. Any issues from these would flow upwards into the regular Executive and Board reporting. •Our Members Relations section on the website provides customers with information on areas such as fund prices, investments and takeovers and acquisitions.

Scottish Friendly is subject to the Senior Managers & Certification Regime (SM&CR) operated by the PRA and FCA to improve culture, governance and accountability within financial services firms.

The Board is satisfied that individual responsibilities have been reviewed, documentation updated and certification of relevant staff undertaken to ensure compliance with the SM&CR.

The Board

The Board met formally on nine occasions in 2020 and informally on two occasions (strategy day with external consultant and November strategy session). There is a schedule of regular reports which the Board considers and which is agreed at least annually. Reports are provided to Board members in advance of the Board and Board Committee meetings. All Directors were present at the meetings.

The Directors' attendance at Board and Committee meetings is set out in the table below (figures in brackets are the total number of meetings held during each Director's tenure). In addition to the Board meetings, the Non-Executive Directors met with Executive Management in November to review strategic objectives and the business plan for the forthcoming year.

The matters considered by the Board, and on which it receives regular reports, cover financial, business conduct, operational and risk matters, including:

- financial performance against budget, data and analysis relating to business volumes, and reports on investment strategy and performance;
- risk management, through the Risk Management Framework; (see Risk Management, below);
- actuarial matters including solvency and capital requirements;
- operational reports on customer service and staff matters; and
- business conduct information, including performance on the six outcomes of the Treating Customers Fairly initiative.

	Board meetings	Audit Committee	Risk Committee	Remuneration Committee	Investment Committee	Nomination Committee	With-Profits Committee
David C Huntley	9 (9)	4 (4)	4 (4)	2 (2)	2 (2)	1 (1)	–
Michael J Walker	5 (5)	–	1 (1)	1 (1)	2 (2)	2 (2)	–
Dermot J Jenkinson	9 (9)	4 (4)	–	1 (1)	–	3 (3)	–
Kerr Luscombe	9 (9)	4 (4)	4 (4)	2 (2)	–	–	4 (4)
Anja Balfour	9 (9)	–	4 (4)	–	4 (4)	–	4 (4)
Gillian Watson	9 (9)	4 (4)	–	2 (2)	–	–	–
Susan Beckett	3 (3)	1 (1)	2 (2)	–	–	–	–
Jim Galbraith	9 (9)	–	4 (4)	–	4 (4)	3 (3)	–
Neil Lovatt	9 (9)	–	–	–	–	–	–
Martin Pringle	9 (9)	–	–	–	4 (4)	–	–

Although many of the powers regarding business conduct, operational management and day-to-day activities of Scottish Friendly are delegated to Executive Management, through the Chief Executive, there is a formal schedule of matters reserved to the Board for approval which includes: the authorisation regime for bank accounts, changes to investment parameters and deals outwith those parameters, transfers of engagement, the budget and the distribution of surpluses and bonuses.

The Board also retains responsibility for a number of statutory duties relating to the prudent management of Scottish Friendly's activities; these include responsibility for maintaining required solvency and liquidity levels as well as maintenance of requisite accounting records and systems of control. The powers retained by the Board, and those delegated to the Chief Executive and to Board Committees, are reviewed at least annually by the Board.

The roles of the Chair and Chief Executive are separate and their respective responsibilities have been agreed and documented.

Scottish Friendly has established a framework of internal controls for the management of risk within its business and to safeguard the interests of members. The framework is designed to manage the risk of failure to achieve business objectives, and to provide reasonable assurance against material misstatement or loss. Further information on Scottish Friendly's approach to Risk Management is set out below.

Report on Corporate Governance (cont)

Risk management

Scottish Friendly maintains a robust Risk Management Framework (RMF) that creates an effective risk management capability across the business. The RMF describes both the strategic aspects of risk management, such as stress testing, as well as the more operational aspects such as risk assessment and assurance.

The components of the RMF are shown below:

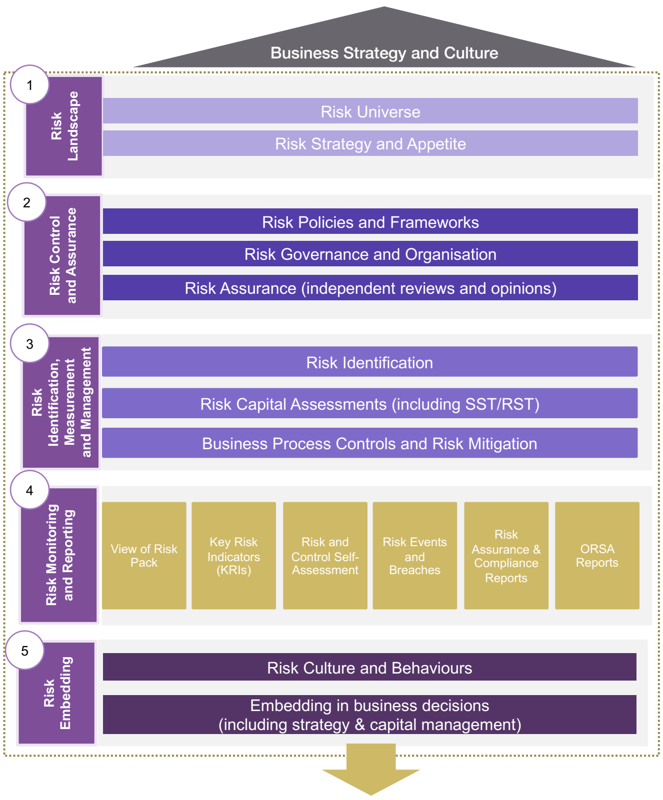
Risk Management Framework

Risk Landscape

The Risk Universe categorises all the risks to which the business is exposed, providing a common language for risk across the business and a structure for assessing and reporting risk. There are three risk categories – Level 1 is the highest level, which is cascaded down to more detail at Levels 2 and 3.

Board approved Risk Appetite Statements (RAS) are in place for each level 1 risk category; these set out the type and amount of risk which Scottish Friendly is willing to accept in pursuit of its strategic objectives and business strategy. When setting risk appetite the Board considers not only the strategic priorities at the point in time assessment, but also what is proposed over the five year business planning period and potential deviations from the agreed strategy.

Risk Management Framework



SST = Stress and Scenario Testing
RST = Reverse Stress Testing

Risk Control and Assurance

Risk policies are in place and owned by the Chief Risk Officer; these define the principles and standards for managing key risks across the business. Each policy has been allocated an Executive Risk Owner (ERO) who is responsible for demonstrating compliance with the standards across the company on an ongoing basis. The Risk Function provide oversight and challenge of this process. A Risk Policy Framework is in place in order to facilitate effective implementation of Scottish Friendly's risk policies across the business.

The overall accountability for risk within the business ultimately rests with the Board. The Board has overall responsibility for the system of internal control and, through a combination of the activities below, is able to review its effectiveness annually, including financial, operational and compliance controls and risk management systems. Its effectiveness has also been reviewed by the Board specifically for the purposes of this statement.

The Board has delegated some responsibilities for risk to the Audit Committee of the Board, to assist the Board in reviewing the systems of internal controls and the external financial reports of the business, and to the Risk Committee of the Board (BRC), to provide focused support and advice on risk governance and to assist the Board in reviewing the systems for managing all aspects of the risk universe. On behalf of the Board, the BRC also conducts an annual assessment of the effectiveness of the Risk function. Further information is set out below on the activities of the Audit and Risk Committees during 2020.

In addition, the Executive Risk Committee (ERC) is the primary forum for Executive oversight and challenge of the risk and control environment across the business and is chaired by the Chief Risk Officer. All Executives are responsible for the identification, assessment, management and control of risks in their respective areas, delegating such parts of this responsibility to appropriate managers or other individuals where practical. Each Executive is required to report on their respective area to the ERC on at least a quarterly basis.

Scottish Friendly operates a 'three lines of defence model' in the management of risk so that there are clearly defined roles and responsibilities within our ERM framework.

First Line

The First Line of Defence is the operational areas across Scottish Friendly which are responsible for the identification and management of day-to-day risks and controls across the business. The management of risks, monitoring of risks and the reporting of breaches of risk appetite are the responsibility of each ERO.

In addition, the governance structure includes first line oversight committees such as the Information Security and Business Continuity Committee (ISBC), Conduct and Product Committee (CAPCOMM), Outsourcing Committee and the Unit Linked Committee. These meetings are chaired by the relevant Executive and membership includes the Risk and Compliance function.

Second line

Risk oversight is provided by the Risk and Risk Assurance and Compliance Functions, reporting to the Chief Risk Officer, Executive Risk Committee and Board Risk Committee. The Risk Function has a clear mandate which is set by the Board and reviewed annually.

The purpose of the second line is to:

- Oversee and ensure the identification and management of risk by the business for the benefit of Scottish Friendly and its customers;
- Provide second-line independent, robust challenge to decisions taken by the business, on behalf of its members and customers, including commercial decisions;
- Engage with the front and back office functions in order to be involved on a timely basis in the decision making process;
- Deliver valuable business insights to allow the Board and Management to make informed decisions;

Report on Corporate Governance (cont)

- Promote a risk-aware culture across the organisation;
- Advise management on compliance with laws and regulations through the establishment and implementation of the compliance policy and plan; and
- Assess the adequacy of the measures the business has in place to prevent non-compliance.

Third line

Independent assurance of the adequacy and effectiveness of our risk and control environment is provided by the Internal Audit Function which delivers a cyclical and prioritised programme of risk based audits covering all aspects of work undertaken in the First and Second Line business areas over a period of years.

Risk management is embedded in the duties and responsibilities of all employees and it is the responsibility of managers to ensure that this approach is maintained, and the responsibility of the ERC to ensure that this is effectively monitored.

Risk Identification, Measurement and Management

- Both current and emerging risks are identified in a number of ways, and start with an understanding of the internal and external uncertainties which exist and the potential impact these have on strategic and business objectives. Risks are identified using a variety of techniques, including business risk self-assessments, risk workshops, horizon scanning and forward looking Key Risk Indicators (KRIs).
- Capital assessment is a key element of the ORSA and considers the level and type of capital that may be appropriate for risks identified over Scottish Friendly's five-year business planning period. Therefore, a forward-looking assessment of capital requirements and capital resources over a five year time horizon, based on Scottish Friendly's risk profile and business/strategic plans, is performed and monitored. This projection also involves an assessment of whether the level of capital coverage is within Scottish Friendly's solvency risk appetite as well as the associated limits/triggers. Stress and scenario testing is used to test the impact of adverse scenarios on the capital coverage and business viability.
- The Risk and Control Self Assessments ('RCSA') - An ongoing process of RCSA is in place for monitoring and managing inherent and residual risk exposures. A key element of the RCSA process is the identification of current and forward looking risks and the management of risk through the assessment of the performance of key controls. This process is performed at both a functional and at a consolidated corporate wide level and is the mechanism for identifying, assessing and reporting the key risks from a strategic perspective. The output of the RCSA process is captured in the Functional and Corporate Risk Registers.
- Risk management and mitigation measures are determined (e.g. reinsurance, capital management plans) by EROs to maintain risk exposure within appetite. The measures in place are in accordance with relevant Risk Policies with oversight from the Risk Function.

Risk Monitoring and Reporting

There is a regular cycle of risk reporting which operates by consolidating the output from the preceding components of the risk management framework to inform decision making, facilitate prompt action, where required, and enable monitoring. Risk reporting flows through the 2nd line of defence and is escalated appropriately through the governance structure.

The Framework comprises the following activities which provide the basis for regular risk reporting:

- **View of Risk Summary:** This is the Risk Function's view of the business' current exposure against risk appetite. It also highlights the key areas of risk change/development over the period for attention, and issues that require prioritised management awareness and response.
- **Key Risk Indicators (KRIs):** For each risk category there are KRIs and associated metrics which enable risk to be measured on an ongoing basis against agreed tolerance levels.
- **Risk events and breaches:** A process operates to record and report risk events and regulatory compliance breaches. The risk events and breaches are included in regular reporting to the Executive as well as the Risk Committees. The reporting includes the root cause analysis, the impact (financial and otherwise), and action taken to prevent recurrence. This reporting enables trends within the business to be identified and take appropriate action to mitigate future occurrence.
- **Risk Assurance and compliance reports:** An annual cycle of reviews undertaken by the second-line of defence. The key objectives of the assurance reviews are to critically review each departments' self-assessment of key controls, opine on the departments' assessment of residual risk, and to advise on best practice in the development of controls.
- **The Own Risk and Solvency Assessment (ORSA):** An integral part of the strategic decision making process within Scottish Friendly and its results inform capital management, investment and product development decisions taken by the Executive and the Board. As well as this, the ORSA creates a link between the risks that are being taken to deliver the strategy and the capital implications that arise as a consequence of the chosen strategy. Emerging risks are closely monitored and assessed within the ORSA process to ensure Scottish Friendly takes appropriate action when required to mitigate or respond to these risks. In addition, on an annual basis the Risk Function leads detailed analysis into the risk profile and projection of risk exposures as part of the ORSA process. The ORSA is presented to the BRC and the Board.

Risk Embedding

A strong firm-wide risk culture is a key element of effective risk management. Scottish Friendly aims to deliver a culture of risk awareness, openness and the promotion of, and embedding of, a set of common 'desired behaviours'. The risk monitoring and reporting processes set out in the RMF are also important in demonstrating a culture of lessons learned and continuous improvement.

The value of risk management for the benefit of our business and policyholders is achieved through embedding risk in key business decisions, day-to-day operations and the management of change:

- This takes place at Board level and in day-to-day management of the business.
- Embedding is supported through provision of insightful and relevant information on risks and proposed measures to manage and respond to risks, together with representation of the second-line of defence at key points in the decision making process.
- The business embed risk management in the day-to-day business processes through operation of effective controls. In addition, there is a process to assess business compliance with the risk policies which is reported to the Risk Committees.
- Embedding risk management in the management of change within our business.
- Embedding of risk supports enhancement of business performance and capital management to the benefit of our policyholders and delivery of Scottish Friendly's strategy.

Report on Corporate Governance (cont)

Principal risks

Once a risk exposure has been identified it is recorded within Scottish Friendly's Risk Universe. The Risk Universe categorises all risks which Scottish Friendly is exposed to into seven broad categories, and each category contains a number of sub-risks. The seven risk categories are:

These can be further split into risks for which capital is held, and risks which are mitigated and managed in other ways e.g. controls and response frameworks.

Risks for which capital is held

These are the risks within the Risk Universe which can be meaningfully quantified and can be mitigated, at least in part, through holding an appropriate amount of capital. These are:

- Insurance risk which is defined as the risk resulting from failure to predict or respond to changes in the level, trend, or volatility of mortality, longevity, morbidity, persistency, and expense experience. This includes the uncertainty in long-term claims experience as a result of COVID-19.
- Market risk which is defined as the risk that market movements focussed on fluctuations or adverse impacts to the value of assets and liabilities result in financial loss or non-financial impact.
- Credit risk which is defined as the risk resulting from the default or failure of third parties to meet their payment obligations, or variations in market values as a result of changes in expectation in relation to these risks, or change in the credit standing of key counterparties. This includes the risk of a weakening in the financial strength of key reinsurance counterparties as a result of adverse claims experience during the COVID-19 pandemic.
- Operational risk which is defined as the risk that inadequate or failed internal processes, systems, people or from external events result in financial loss or non-financial impact, including reduced operational resilience, customer and reputational impacts.
- Conduct risk which is defined as the risk of poor outcomes for customers resulting from the acts of Scottish Friendly, associated third parties and/or individuals within the firm.

These risks are mitigated by holding sufficient capital to ensure that Scottish Friendly is able to withstand a very extreme scenario, equivalent to a 1 in 200 year event, whereby a combination of these risks occur concurrently.

Risks which are not well mitigated by holding capital

These are the risks within the Risk Universe which cannot be meaningfully quantified and so are not well mitigated by holding capital. These are:

- Strategic, Business Environment and Reputational risks (SBER) are risks that could impact on the ability to deliver the business strategy over the business planning horizon. On this basis, they are significant risks that require ongoing monitoring and management. Scottish Friendly mitigates against SBER risks through monitoring and horizon scanning, as well as a combination of strategic and operational steps. Scottish Friendly has strategic diversification from the manufacturing of a diverse product range, distributed through a number of channels to multiple target markets. In addition, there are robust operational controls to minimise the impact of events that could harm reputation as well as continued investment in people, systems and processes to strengthen the business' resilience to internal and external events.

- Liquidity risk is defined as the risk resulting from Scottish Friendly being unable to realise investments and other assets in order to settle its financial obligations when they fall due. This risk is mitigated by holding a proportion of assets in cash and other instruments which can be liquidated at short notice.

Key Emerging Risks

Key emerging risks are new or changing risks that can have a serious impact on the business environment or broader society. These risks are known to some degree, but may not materialise or have an impact for several years. Scottish Friendly recognises and incorporates emerging risks in strategic planning.

The top three key SBER and emerging risks identified in the 2020 ORSA process are:

- An 'unequal' economic recovery from Covid-19 – The Covid-19 pandemic has had a significant economic impact globally. While there are some signs of recovery, the long-term economic outlook remains uncertain, and is highly sensitive to changes in the course of the pandemic, as well as any new Government austerity measures or withdrawal of fiscal stimulus, which could impact the lowest paid in society disproportionately. In this environment, new business sales would be challenging and there could also be an impact on the backbook as policyholders reduce or withdraw savings. Scottish Friendly's diverse business model helps to partly mitigate this risk.

- Societal changes in ways of working / living - The immediate impacts of Covid-19 on societal change are beginning to emerge but significant uncertainty remains over the medium and longer term impacts. Potential societal changes could impact on demand for, or distribution of, savings and long-term protection products. Strategically these changes presents both downward risks and upside opportunities for Scottish Friendly.

- Climate change – the issues from climate change are a global concern. There is an increasing expectation from regulators that financial services firms should be taking actions to directly reduce their own impact on the climate, as well as driving climate change action within the wider economy through active investment stewardship. Scottish Friendly will continue to develop and integrate the assessment of climate-related risks and opportunities into our strategy, decision-making, risk management and reporting frameworks. Scottish Friendly seeks to operate in a sustainable and responsible way. Operationally, prior to Covid-19 all staff were based in a single location, which minimises business travel, and the business is increasingly moving to a "paper-free" operating environment. The potential financial impact of climate change on Scottish Friendly's solvency position was assessed through scenario analysis in the 2020 ORSA, based on guidance previously issued by the PRA. This scenario analysis demonstrated that climate change did not have a significant impact on Scottish Friendly's solvency position. As a key emerging and strategic risk to Scottish Friendly we will continue to develop our approach as well as metrics to assess the potential business impacts of climate-related risks.

In addition, further SBER and emerging risks identified in the 2020 ORSA were:

- Scottish Independence - constitutional change may have an impact on Scottish Friendly and developments are monitored by the Board.
- Current and next wave technology - Failing to keep pace with the next wave of digital and technological change will mean Scottish Friendly loses its cost advantage, impairs its ability to work in an agile manner, or fails to meet customer expectations.

These key SBER and emerging risks are monitored closely by the Board, allowing Scottish Friendly to develop or modify strategies to either minimise the negative effects or capitalise on the potential opportunities that an emerging risk may present.

Report on Corporate Governance (cont)

Directors

Brief biographies of the current Directors are set out on page 17.

In addition to the Chair and Vice-Chair, the Board comprised, as at 31 December 2020, four other Non-Executive Directors and three Executive Directors, being the Chief Executive, the Commercial Director and the Finance Director. This composition is considered to provide an effective and balanced mix of skills and experience to meet the Board's remit.

The Nomination Committee has reviewed the length of service of the Non-Executive Directors and considers that they all meet the criteria of independence.

Dermot Jenkinson continued as the Senior Independent Director; as such, he may, as necessary, lead meetings of the independent Non-Executive Directors (with/without the Chair being present), be available to members through the Member Relations function to understand their concerns (in the event that other contacts within Scottish Friendly are inappropriate or have failed) and to present these views to the Board as a whole, and to lead the performance evaluation of the Chair. He is also the whistleblowing champion.

Scottish Friendly's rules provide for all Directors to stand for re-election at least once every three years. If any member of the Board who does not also hold or has not held an executive position with Scottish Friendly has been a member of the Board for nine years or more, that member of the Board is subject to annual re-election at the Annual General Meeting.

In line with the Code, the submission of any Non-Executive Director for re-election for a term which means they would serve more than six years is subject to particular review, taking into account the need for progressive refreshing of the Board.

Particulars of Directors' remuneration are given in the Directors' Remuneration Report on pages 39 to 40.

Performance evaluation

On at least an annual basis, the Chair conducts a performance evaluation of each Director in order to verify that each continues to contribute effectively and demonstrate commitment, including time commitment, to the role. Feedback from the evaluation is communicated individually to the Director by the Chair. The performance of the Chair is reviewed by the Non-Executive Directors, led by the Senior Independent Director, taking into account the views of the Executive Directors. Executive Directors are appraised in respect of their Directorial duties.

The performance of the Board and its Committees is also considered on at least an annual basis and the results shared with the Board as a whole.

Board Committees

The terms of reference of the current Committees of the Board – Audit, Risk, Remuneration, Nomination, Investment and With-Profits Committee – are available on the Scottish Friendly website https://www.scottishfriendly.co.uk/about-us/board-committee-terms-reference. Membership of the Committees of the Board is intended to make best use of the skills and experience of the Directors. The work carried out during 2020 by the Audit, Risk, Nomination, Investment and With-Profits Committees in discharging their responsibilities is summarised below. The work carried out by the Remuneration Committee is described within the Directors' Remuneration Report on pages 39 to 40.

Audit Committee

- **Kerr Luscombe (Chair)**
- **Dermot Jenkinson**
- **David Huntley (until May 2020)**
- **Gillian Watson**
- **Susan Beckett (appointed September 2020)**

The terms of reference of the Audit Committee include all matters indicated by the Code. The Committee consisted of four independent Non-Executive Directors, at least one of whom has recent and relevant financial experience, in line with the Code. The Company Secretary acted as Secretary to the Committee. In addition the Chair, CEO and CRO all attend the Audit Committee meetings.

During 2020 the Committee met formally on four occasions. The Committee:

- reviewed the internal control systems, including internal financial controls and ensured that these continued to be effective; advised the Risk Committee as appropriate of any concerns regarding the effectiveness of the current control framework;
- considered the External Audit Plan which highlighted key judgement areas and summarised changes in reporting requirements;
- reviewed the annual financial statements and annual regulatory returns including Solvency II reporting and the Solvency and Financial Condition Report (SFCR) and approved them for submission to the Board. The Committee focused particularly on major judgemental areas and compliance with accounting standards and legal requirements, including the regulations and guidance of the PRA. The Committee reviewed thoroughly the external auditor's detailed report on the draft documents and obtained satisfactory explanations where necessary. The Committee also reviewed the external auditor's final report on internal controls and ensured that follow up action was appropriate and completed where necessary;
- approved the internal audit programmes and received regular progress reports from internal audit and ensured that recommendations made were followed up by management. Individual internal audit reviews are scheduled both according to regular assessments of key risk areas on a cyclical approach supplemented with matters of a topical nature. The Committee also monitored co-ordination between the internal and external auditors and ensured that the internal audit function was adequately resourced and had appropriate standing within the organisation;

- reviewed the internal audit charter which follows guidance from the Chartered Institute of Internal Auditors;
- reviewed the policyholder focus group review of the Report and Accounts and their ease of understanding exercise and considered recommendations for enhancements to the Report and Accounts;
- assessed the effectiveness of the external and internal audit processes through the reporting that it receives from the respective auditors who were present at each Committee meeting. The Committee meets with each of internal and external audit in the absence of management at least once a year; and
- reviewed and ensured the fulfilment of the terms of reference of the Committee and examined Committee effectiveness.

In planning its work and reviewing the audit plan of the external auditors, the Committee took account of the most significant issues and risks, both operational and financial, likely to impact on the Group's financial statements. The two areas which have most impact on the financial statements and returns are:

- the calculation of life insurance technical provisions and reinsurance valuation on a Solvency II basis. The Audit Committee reviews these on behalf of the Board including reports from the Head of Actuarial covering methodology, assumptions, significant judgements and other factors impacting the provisions and recommends their approval to the Board. Over 2020, this included detailed consideration of the potential impact of the Covid-19 pandemic on future experience; and
- the appropriate recording and valuation of the investment portfolio, particularly the valuation of less liquid and more complex investments. Approximately 99% of the investment portfolio by value can be verified against daily market prices. Scottish Friendly uses appropriate independent safeguarding and custodian arrangements. The Committee has reviewed the control environment as relates to investments, including relevant internal or external audit activity.

Both the Board and the external auditor have safeguards in place to prevent the auditor's independence and objectivity being compromised. The external auditor reports regularly to the Committee on the actions that it has taken to maintain its independence. Deloitte was first appointed as auditor following a tendering exercise in 2012. No issues with the independence of Deloitte were identified.

Investment Committee

- **Anja Balfour (Chair)**
- **Michael Walker (Retired May 2020)**
- **Jim Galbraith**
- **David Huntley (from May 2020)**
- **Alan Rankine**
- **Bryan Johnston (retired June 2020)**
- **Martin Pringle**

During 2020 the Committee met on four occasions. The Company Secretary acts as Secretary to the Committee. The Investment Committee oversees Scottish Friendly's investment holdings and performance on behalf of the Board. The terms of reference of the Committee include setting asset allocation and investment strategy of the Scottish Friendly funds in line with the liability profile, relevant risk appetite and parameters established by the Board or by the relevant fund objective, and also monitoring risk appetite, investment parameters and fund objectives, making recommendations to the Board as appropriate. External fund managers were invited to present to the Committee at an investment away day and investment advisors are invited to give regular updates on an ongoing basis. During the year the Committee reviewed and ensured the fulfilment of the terms of reference and examined Committee effectiveness.

Nomination Committee

- **Michael Walker (retired May 2020)**
- **David Huntley (Chair, appointed May 2020)**
- **Jim Galbraith**
- **Dermot Jenkinson**

During 2020 the Committee met formally on three occasions. The Company Secretary acts as Secretary to the Committee. The Committee ensures that plans are in place for orderly succession for appointments to the Board. The Committee leads the process for such appointments and makes recommendations to the Board, taking into consideration the time commitments required of Non-Executive Directors and their independence.

It considers the overall balance of skills, experience and knowledge to ensure that Directors bring informed and independent judgement to the Board. The Committee also ensures that Scottish Friendly's employee policies, described on page 15, are applied in Board nomination matters.

Scottish Friendly has a Board diversity policy and the Nomination Committee annually reviews the composition of the Board and considers the balance of competencies to ensure alignment to Scottish Friendly's strategic priorities.

Risk Committee

- **Susan Beckett (Chair, appointed September 2020)**
- **Kerr Luscombe**
- **Michael Walker (retired May 2020)**
- **David Huntley (until September 2020)**
- **Jim Galbraith**
- **Anja Balfour**

The Risk Committee provides focused support and advice on risk governance, assisting the Board in reviewing the systems for managing all aspects of business risk. The Committee takes account of the most significant issues and risks, both operational and financial, likely to impact on the Group's financial statements.

During 2020 the Committee met on four occasions. The Company Secretary acts as Secretary to the Committee.

The Committee:

• reviewed, challenged and approved the revised Risk Appetite Methodology and recommended Risk Appetite Statements for Board approval, including monitoring measures with limits and triggers that are the basis for regular ORSA reporting;

• shaped the design and content of the Annual ORSA report to meet the requirements of the Board in terms of risk insights and forward-looking threats. In particular reviewing the Solvency II regulations, with specific focus on risks inherent in the strategy, the overall solvency needs assessment, and the adequacy of the stress and scenario testing;

• received regular reports from the second-line teams outlining the key prudential, operational and conduct risks facing Scottish Friendly and the controls and actions in place to mitigate their impacts. This included updates on the Compliance Monitoring plan and any actions arising from Compliance Reviews and Risk Assurance reviews during the period;

• oversaw risk exposure relative to appetite and the actions taken by management to manage principle risks; and

• reviewed and ensured the fulfilment of the terms of reference of the Committee and examined Committee effectiveness.

With-Profits Committee

- **David Gulland (Chair)**
- **Anja Balfour**
- **Lorna Blyth**
- **Kerr Luscombe**

During 2020 the Committee met formally on four occasions and also supported several additional ad-hoc meetings to consider market turbulence during the year. The Company Secretary acts as Secretary to the Committee.

The role of the Committee is, as relevant, to assess, report on, and provide clear advice and, where appropriate, recommendations to the Board on:

• the way in which each With-Profits fund is managed by Scottish Friendly and, if a PPFM is required, whether this is properly reflected in the PPFM;

• if applicable, whether the firm is complying with the principles and practices set out in the PPFM;

• any proposed changes which would result in revisions to the PPFM;

• whether the firm has addressed effectively the conflicting rights and interests of with-profits policyholders and other policyholders or stakeholders in a way that is consistent with Principle 6 of the FCA Handbook (treating customers fairly);

• reviewed and ensured the fulfilment of the terms of reference of the Committee and examined Committee effectiveness; and

• any other issues with which the Board or Committee considers with-profits policyholders might reasonably expect the Committee to be involved.

Member Relations

Scottish Friendly's Delegate system has proven to be an effective model for communication with members and will continue to be the cornerstone around which Scottish Friendly fulfils its responsibilities to engage with, and be accountable to, its members. There are currently 30 Delegate positions (29 filled), elected to represent geographic constituencies and Delegate positions are advertised annually for the one third retiring by rotation.

The Annual General Meeting provides an opportunity to inform the Delegates on business performance and future strategy. This is supplemented by additional Delegates' meetings held at least annually. Delegate attendance at meetings has always been very good.

Scottish Friendly's member relations strategy includes hosting a dedicated members' area at www.scottishfriendly.co.uk/customer-centre on the Scottish Friendly website which promotes two-way communication by providing access to information of particular relevance to members and through a dedicated email link which members can use to provide feedback. This members' area also includes dedicated areas for those members joining as a result of transfers of business.

Directors' Remuneration Report

Remuneration Committee

- **Dermot Jenkinson (Chair, appointed October 2020)**
- **Michael Walker (retired May 2020)**
- **David Huntley (interim Chair until October 2020)**
- **Kerr Luscombe**
- **Gillian Watson**

The terms of reference of the Remuneration Committee include reviewing the remuneration of the Chair, and determining appropriate levels of Executive Management remuneration.

The Committee consists of three independent Non-Executive Directors, as well as David Huntley, who was considered independent on appointment, in line with the Code.

Scottish Friendly's policy is to provide a competitive remuneration package which will attract and retain the appropriate calibre of Executive and Non-Executive Directors.

Executive Director salaries are reviewed annually. A range of data is taken into account to inform the review including comparable positions in other organisations, remuneration trends in the financial services sector, as well as wider economic influences. Any change to salary is effective from 1 January. The Remuneration Committee ensures that it remains appraised of these factors and of best practice, taking external advice where appropriate.

The remuneration package for Executive Directors incorporates a performance element which is targeted at delivering growth and cost efficiencies while generating longer term value for members. Payments are capped at 100% of salary as per Solvency II requirements for ad hoc discretionary bonuses e.g. as a result of acquisitions. 40% of bonus payments may be deferred for three years, if applicable.

The Executive Directors' benefits include a company car and healthcare insurance where applicable.

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

Fees for the Chair are set by the Committee in his absence and for Non-Executive Directors are set by the Executive Directors and the Chair. Fees are designed to recognise the responsibilities of Non-Executive Directors and to attract individuals with the necessary skills and experience to contribute to the future development of Scottish Friendly.

Fees are made up of an annual fee covering Board and Committee membership. Additional fees are payable to the Vice-Chair and to the Chairs of the Audit, Risk, Remuneration and Investment Committees, as well as With-Profits Committee members, in respect of the additional responsibilities relating to those roles. Fees are neither performance-related nor pensionable and Non-Executive Directors do not receive any additional benefits.

Non-Executive Directors receive reimbursement of travel and accommodation costs where required for attending meetings.

Service contracts

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

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

Directors’ emoluments (audited)

	Salary and fees £000	Performance pay £000	Entitled performance pay deferred £000	Benefits [1] £000	Year ended 31 Dec 2020 £000	Year ended 31 Dec 2019 £000
Chair						
David C Huntley [2]	78	–	–	1	79	60
Executive Directors						
Jim Galbraith	475	120	80	62	737	675
Neil Lovatt	186	65	–	26	277	251
Martin Pringle	200	80	–	20	300	279
Non-Executive Directors						
Michael J Walker [2]	38	–	–	1	39	93
Anja Balfour	60	–	–	–	60	53
Dermot J Jenkinson	53	–	–	–	53	51
Kerr Luscombe	60	–	–	–	60	53
Gillian Watson	45	–	–	–	45	45
Susan Beckett [2]	15	–	–	–	15	–

[1] For Executive Directors, benefits comprise the provision of a company car and healthcare insurance payments covering notice periods, as well as, the provision of pay in lieu of pension contributions. For the Non-Executive Directors, figures in the benefits column comprise travel and accommodation cost reimbursements.

[2] Michael Walker retired as Chair on 27 May 2020; David Huntley appointed as Chair on 28 May 2020, Susan Beckett appointed to Board on 23 September 2020

Accounts

Independent Auditor's Report To The Members Of Scottish Friendly Assurance Society Limited

Report on the audit of the financial statements

Opinion

In our opinion the financial statements of Scottish Friendly Assurance Society and its subsidiaries (the "group"):

- give a true and fair view of the state of the group's and of the Scottish Friendly's affairs as at 31 December 2020 and of the group's and Scottish Friendly's income and expenditure for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including Financial Reporting Standard 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland"; and
- have been prepared in accordance with the requirements of the Friendly Societies Act 1992.

We have audited the financial statements which comprise:

- the group and Scottish Friendly income and expenditure accounts;
- the group and Scottish Friendly balance sheets; and
- the related notes 1 to 15 and 17 to 22, excluding the capital disclosures in note 16 calculated in accordance with the solvency II regime.

The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards, including Financial Reporting Standard 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland" (United Kingdom Generally Accepted Accounting Practice).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the group and Scottish Friendly in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (the 'FRC's') Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the group or Scottish Friendly.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters	The key audit matters that we identified in the current year were: • Actuarial Assumptions – Cost of Guarantees and the setting of assumptions around future mortality and morbidity in the protection business; and • Valuation of illiquid and complex investments. Within this report, key audit matters are identified as follows:
Materiality	The materiality that we used for the group financial statements was £5,900,000 which was determined on the basis of Funds for Future Appropriation ("FFA").
Scoping	Our group audit scope included the audit of the subsidiary components. The audits of the components were performed at materiality levels determined with reference to the scale of the business concerned and, other than Scottish Friendly, these were significantly lower than group materiality, being set up to £82,000 and Scottish Friendly materiality was £5,600,000.

Significant changes in our approach	There were no significant changes to our audit approach during the year. In comparison to the prior year, we have not identified a separate Key Audit Matter for the current year relating to the appropriateness of the Covid-19 post balance sheet event disclosures, as these are no longer relevant. However, as outlined in Section 5.1, we have assessed and evaluated how management had taken account of the additional uncertainty that exists as a result of the impact of Covid-19 on the setting of the mortality and morbidity assumptions in the protection business.

Conclusions relating to going concern

In auditing the financial statements, we have concluded that the Directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate.

Our evaluation of the Directors' assessment of the group's and Scottish Friendly's ability to continue to adopt the going concern basis of accounting included the following:

- evaluated management's stress and scenario testing, and challenged management's key assumptions. In conjunction with internal actuarial specialists, we reviewed the governance over, and the production of, solvency monitoring information, and considered its consistency with other available information and our understanding of the business;
- assessed the actions that came out of the various governance committee meetings which considered Covid-19 in advance of signing the financial statements
- evaluated management's assessment of the risks across the group, including: solvency risk, liquidity risk, and operational matters;
- assessed the mitigating actions management have put in place, and further plans they have if required, in anticipation of any further deterioration of the wider UK and Global economy as a result of Covid-19 or Brexit; and
- assessed the going concern disclosures made by management in the financial statements, based on our knowledge gained throughout the audit.

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the group's and Scottish Friendly's ability to continue as a going concern for a period of at least twelve months from when the financial statements are authorised for issue.

Our responsibilities and the responsibilities of the Directors with respect to going concern are described in the relevant sections of this report.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Actuarial Assumptions – Cost of Guarantees and the setting of assumptions around future mortality and morbidity in the protection business

Key audit matter description

The group's technical provisions represent an assessment of the liabilities arising from insurance and investment contracts. These include:

- Protection policies that contain a guaranteed payment on death, disability or illness, depending on the terms of the contract;
- Other insurance contracts with guarantees that can increase the benefits payable to the policyholder.

The calculation of technical provisions for insurance contracts requires management to make significant judgements about assumptions and methodology. Judgements include estimates of future deaths, future sickness, voluntary contract terminations, investment returns and administration expenses. In addition, these balances are some of the most significant in the group's financial statements; with-profit insurance contracts valued at £816m (2019: £872m) and non-profit insurance contracts at £925m (2019: £804m), comprising the total output from various actuarial models for the group's insurance products.

Our key audit matter is pinpointed to two specific areas of significant judgement:

- The valuation of technical provision related to the protection business is highly sensitive to the setting of the mortality and morbidity assumptions, which require the application of significant judgement, especially in relation to the additional uncertainty that exists as a result of the impact of Covid-19.
- The reserves held for future costs relating to guarantees. These costs of guarantees ('CoG') are complex and material, calculated using a stochastic model based on a variety of possible economic scenarios.

Due to the significant assumptions and judgements involved, we determined that there was a potential for fraud through possible manipulation of key assumptions and judgements in these balances.

The technical provisions are set out in Note 11. The related accounting policy and management's consideration of significant judgements and estimates is on Note 2.

How the scope of our audit responded to the key audit matter

We obtained an understanding of the relevant internal controls put in place by management to manage the setting of technical provision assumptions.

We worked closely with our actuarial specialists to test the economic assumption inputs and calibration of the stochastic models that determine CoG reserves. We challenged the key movements in the reserve over the period, as well as changes in methodology. In particular, we challenged management's actuarial function on the testing of the Economic Scenario Generator ("ESG") model output, used as an input to the CoG model, by assessing the inputs to the model and the outputs of the ESG model. We also tested the movements in the CoG 'analysis of change' by considering market and policy value movements in 2020.

Together with our actuarial specialists, we challenged management's mortality and morbidity assumptions applied to the protection business by assessing the results of management's experience data analyses and understanding the rationale for any significant changes in assumptions. In particular, we assessed and evaluated the work of management's advisors, and considered how management had taken account of the additional uncertainty that exists as a result of the impact of Covid-19 on the setting of the mortality and morbidity assumptions in the protection business.

We tested the underlying experience data for completeness and accuracy and verified that it was used appropriately in establishing these assumptions.

For the actuarial models applicable to CoG and the protection business, we assessed the model code to determine whether any changes to the models were implemented appropriately.

Key observations

The reserves held for future costs of guarantees ('CoG') were considered to be appropriately calculated using a stochastic model based on a variety of possible economic scenarios.

The mortality and morbidity actuarial assumptions applied to the protection business and the resulting technical provisions presented in the financial statements were considered to be reasonable.

Valuation of less liquid and complex investments

Key audit matter description

Investments represent Scottish Friendly's most significant asset balance, £3.4bn at 31 December 2020 (£3.5bn at 31 December 2019), and are key to matching insurance liabilities. The investments held are concentrated in collective investment schemes, with prices quoted in active markets.

We identified a key audit matter relating to the material asset types with an increased level of management judgement and inherent complexity, being:

- Investments in property funds of £66m, which are primarily open-ended and therefore carry a higher liquidity risk, and
- Swaption contracts valued at £27m, which are complex derivative contracts that provide Scottish Friendly with an option to enter into an interest rate swap at the expiry date.

Due to the level of judgements involved and the inherent complexity, we determined that there was a potential for fraud through possible manipulation of key assumptions in these balances.

Further details are included within the critical accounting judgements and sources of estimation uncertainty section in Note 2 and financial instruments disclosures in Note 9 to the financial statements.

How the scope of our audit responded to the key audit matter

We obtained an understanding of the relevant internal controls put in place by management to verify the valuation of investments held.

For the investments in property funds, we independently tested the market prices used to value these investments to third party sources. We reviewed the recent performance of the property funds, on both an absolute basis and against peers or benchmark indices, and performed targeted research using independent sources. We assessed the appropriateness of management's assumptions in valuing any property funds that were suspended from trading at the balance sheet date. We analysed the investments to check for stale prices through assessing the activity of the investments.

In order to test the completeness of the property fund population amid the wider investments held, we independently obtained a listing of benchmark index composites, to determine that all such investments held by Scottish Friendly had been appropriately identified.

For the swaption contracts, we worked with our complex pricing derivative specialists to calculate a point estimate fair value of the swaptions as at the year end, based on our inspection of the underlying contracts and other inputs that were independently sourced. In addition, we determined an acceptable range of fair values for each swaption contract, varying market data assumptions to the extent that they are deemed reasonable, and assessed management's valuation against this range.

Key observations

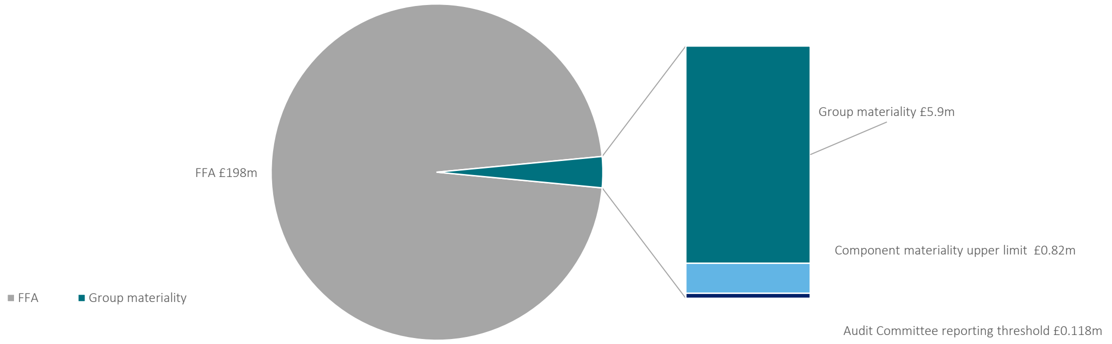
From the work that was performed the property fund investments and the swaption valuations were considered to be reasonable.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Scottish Friendly financial statements
Materiality	£5,900,000 (2019: £5,600,000)	£5,600,000 (2019: £5,320,000)
Basis for determining materiality	3% (2019: 2.9%) of Funds for Future Appropriation ('FFA')	3% (2019: 2.9%) of Funds for Future Appropriation ('FFA')
Rationale for the benchmark applied	FFA represents funds not yet allocated to policyholders and is considered an equivalent to a net asset figure in accounting for Friendly Societies.	FFA represents funds not yet allocated to policyholders and is not considered an equivalent to a net asset figure in accounting for Friendly Societies Scottish Friendly represents the largest component of the group with 99.97% (2019: 99.97%) of the total asset position being composed of Scottish Friendly held assets. As such, a component materiality threshold cap of 95% of group materiality (2019: 99%) has been applied to reflect the significance of Scottish Friendly to the group structure.



Performance materiality

We set performance materiality at a level lower than materiality to reduce the probability that, in aggregate, uncorrected and undetected misstatements exceed the materiality for the financial statements as a whole.

	Group financial statements	Scottish Friendly financial statements
Performance materiality	60% (2019: 70%) of group materiality	60% (2019: 70%) of Scottish Friendly materiality
Basis and rationale for determining performance materiality	In determining performance materiality, we considered the quality of the control environment and whether we were able to rely on controls, the nature of the balances and the high level of audit adjustments identified in the previous audit. As a result of the further pressures on the control environment as a result of the current Covid-19 environment, the performance materiality was reduced to 60% for the current year.	

Error reporting threshold

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £118K (2019: £112K), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

Our group audit scope included the audit of the subsidiary components and Scottish Friendly. The audits of the components were performed at materiality levels calculated with reference to the scale of the business concerned and these were significantly lower than group materiality being set up to £82,000 (2019: up to £81,000).

Scottish Friendly materiality was set at £5,600,000 (2019: £5,320,000) after consideration of the significance of Scottish Friendly to the group structure. All of the audit work to respond to the risks of material misstatement was performed directly by the Group audit engagement team.

Other information

The other information comprises the information included in the annual report, Note 16 and the risk disclosures in Note 24 which are marked as unaudited, and excludes the other elements of the financial statements and our auditor's report thereon. The Directors are responsible for the other information contained within the annual report.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the course of the audit, or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether this gives rise to a material misstatement in the financial statements themselves. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

We have nothing to report in this regard.

Responsibilities of Directors

As explained more fully in the Directors' responsibilities statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the Directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Directors are responsible for assessing the group's and Scottish Friendly's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the Directors either intend to liquidate the group or Scottish Friendly or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Extent to which the audit was considered capable of detecting irregularities, including fraud

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud is detailed below.

Identifying and assessing potential risks related to irregularities

In identifying and assessing risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, we considered the following:

- the nature of the industry and sector, control environment and business performance including the design of the group's remuneration policies, key drivers for Directors' remuneration, bonus levels and performance targets;
- results of our enquiries of management and the audit committee about their own identification and assessment of the risks of irregularities;
- any matters we identified having obtained and reviewed the group's documentation of their policies and procedures relating to:
    - o identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
    - o detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud
    - o the internal controls established to mitigate risks of fraud or non-compliance with laws and regulations;
- the matters discussed among the audit engagement team and relevant internal specialists, including tax, valuations, pensions, IT, and actuarial specialists regarding how and where fraud might occur in the financial statements and any potential indicators of fraud.

As a result of these procedures, we considered the opportunities and incentives that may exist within the organisation for fraud and identified the greatest potential for fraud in the following areas: (i) actuarial assumptions related to cost of guarantee reserves and to future mortality and morbidity in the protection business, (ii) valuation of less liquid and complex investments, and (iii) in recording of premiums for the protection business. In common with all audits under ISAs (UK), we are also required to perform specific procedures to respond to the risk of management override.

We also obtained an understanding of the legal and regulatory frameworks that the group operates in, focusing on provisions of those laws and regulations that had a direct effect on the determination of material amounts and disclosures in the financial statements. The key laws and regulations we considered in this context included the Friendly Societies Act 1992, and tax and pension legislation.

In addition, we considered provisions of other laws and regulations that do not have a direct effect on the financial statements but compliance with which may be fundamental to the group's ability to operate or to avoid a material penalty. These included applicable rules set by the Financial Conduct Authority ('FCA') and the Prudential Regulation Authority ('PRA').

Audit response to risks identified

As a result of performing the above, we identified two key audit matters related to the potential risk of fraud (i) actuarial assumptions related to cost of guarantee reserves and the setting of assumptions on future mortality and morbidity in the protection business, and (ii) the valuation of less liquid or complex investments. The key audit matters section of our report explains the matters in more detail and also describes the specific procedures we performed in response to those key audit matters.

In addition to the above, our procedures to respond to risks identified included the following:

- reviewing the financial statement disclosures and testing to supporting documentation to assess compliance with provisions of relevant laws and regulations described as having a direct effect on the financial statements;
- enquiring of management, the audit committee and external legal counsel concerning actual and potential litigation and claims;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- reading minutes of meetings of those charged with governance, reviewing internal audit reports and reviewing correspondence with HMRC, the PRA and the FCA; and
- in addressing the risk of fraud in revenue recognition, substantiating premiums recorded for the protection business by tracing third party invoices/data, tracing cash flows through bank statements and determining that all 12 months of third party invoices in the year had been appropriately recorded; and
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments; assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists, and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

Opinions on other matters prescribed by the Friendly Societies Act 1992

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and the Directors' report have been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the group and Scottish Friendly and their environment obtained in the course of the audit, we have not identified any material misstatements in the strategic report or the Directors' report.

Matters on which we are required to report by exception In our opinion, based on the work undertaken in the course of the audit:

Adequacy of explanations received and accounting records

Under the Friendly Societies Act 1992 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by Scottish Friendly; or
- Scottish Friendly's financial statements are not in agreement with the accounting records; or
- we have not received all the information and explanations and access to documents we require for our audit.

We have nothing to report in respect of these matters.

Other matters which we are required to address

Auditor tenure

Following the recommendation of the audit committee, we were appointed by Scottish Friendly's Board on 7 August 2012 to audit the financial statements for the year ending 31 December 2012 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 9 years, covering the years ending 31 December 2012 to 31 December 2020.

Consistency of the audit report with the additional report to the audit committee

Our audit opinion is consistent with the additional report to the audit committee we are required to provide in accordance with ISAs (UK).

Use of our report

This report is made solely to Scottish Friendly's members, as a body, in accordance with section 73 of the Friendly Societies Act 1992. Our audit work has been undertaken so that we might state to Scottish Friendly's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than Scottish Friendly and Scottish Friendly's members as a body, for our audit work, for this report, or for the opinions we have formed.

Stephen Williams (Senior statutory auditor)

For and on behalf of Deloitte LLP

Statutory Auditor

Glasgow, United Kingdom

31 March 2021

Income and Expenditure

Technical Account – Long Term Business
For year ended 31 December

	Note	Group 2020 £000	Group 2019 £000	Scottish Friendly 2020 £000	Scottish Friendly 2019 £000
Earned Premiums		146,136	125,529	146,136	125,529
Reinsurance Premiums		(61,694)	(51,699)	(61,694)	(51,699)
Earned Premiums, Net of Reinsurance	3	84,442	73,830	84,442	73,830
Investment Income	4	119,245	60,323	119,245	60,323
Unrealised Gains/(Losses) on Investments		27,547	124,596	28,169	125,414
Other Technical Income		47,466	21,055	44,968	18,565
Amortisation of Negative Goodwill	22	6,062	1,002	6,062	1,002
		284,762	280,806	282,886	279,135
Claims Incurred		222,705	175,730	222,705	175,730
Reinsurance Claims		(90,010)	(80,987)	(90,010)	(80,987)
Net Claims Incurred	5	132,695	94,743	132,695	94,743
Change in Other Technical Provisions		81,566	106,845	81,566	106,845
Operating Expenses	6	62,224	55,966	62,224	55,966
Investment Expenses & Charges		3,054	825	3,054	825
Other Technical Charges		2,505	2,555	794	1,079
Tax attributable to Long Term Business	8	(2,461)	11,150	(2,626)	10,954
Actuarial (Gain)/Loss re pension scheme		(7,524)	2,484	(7,524)	2,484
Transfer to the Fund for Future Appropriations		12,703	6,238	12,703	6,238
		284,762	280,806	282,886	279,134

Except as disclosed above, there are no recognised gains or losses for the year. All results are derived from continuing operations.

The inclusion of unrealised gains and losses reflects the marking to fair value of investments in the balance sheet.

The notes on pages 53 to 83 form an integral part of these accounts

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Balance Sheet

ASSETS As at 31 December	Note	Group 2020 £000	Group 2019 £000	Scottish Friendly 2020 £000	Scottish Friendly 2019 £000
Investments					
Land & Buildings		3,500	3,500	3,500	3,500
Other Financial Investments		1,175,387	1,197,425	1,175,090	1,197,146
Investments in Group Undertakings		–	–	3,910	3,448
Non linked Financial Investments		1,178,887	1,200,925	1,182,500	1,204,094
Assets Held to Cover Linked Insurance & Investment Liabilities		2,230,570	2,309,535	2,230,570	2,309,535
Total Financial Investments	9	3,409,457	3,510,460	3,413,070	3,513,629
Reinsurers' Share of Technical Provisions					
With-profit Insurance Contracts	11	404,947	426,307	404,947	426,307
Non-profit Insurance Contracts	11	654,878	557,805	654,878	557,805
Investment Contracts	11	491,502	539,441	491,502	539,441
Debtors					
Deposits held for Reinsurers	18	9,398	7,975	9,398	7,975
Debtors arising out of Direct Insurance Operations		12,264	10,495	12,264	10,495
Taxation recoverable		277	277	277	277
Other Debtors		39,485	2,032	40,345	1,789
Other Assets					
Tangible Assets	10	853	511	853	511
Negative Goodwill	22	(53,535)	(59,597)	(53,535)	(59,597)
Pension Scheme Surplus	13	20,685	10,441	20,685	10,441
Cash at Bank & In Hand		108,852	110,427	103,684	106,014
Prepayments & Accrued Income					
Prepayments & Accrued Interest, Dividends & Rents		279	295	279	295
		5,099,342	5,116,869	5,098,647	5,115,382
LIABILITIES As at 31 December					
Funds for Future Appropriations		203,595	190,890	203,595	190,890
Technical Provisions					
With-profit Insurance Contract Liabilities	11	816,030	872,042	816,030	872,042
Non-profit Insurance Contract Liabilities	11	925,924	803,899	925,924	803,899
Unit linked Insurance Contract Liabilities	11	296,912	316,968	296,912	316,968
Investment Contract Liabilities	11	2,753,862	2,832,589	2,753,862	2,832,589
Claims Outstanding		32,500	20,246	32,365	20,246
Creditors					
Deposit Received from Reinsurers	17	40,550	42,433	40,550	42,433
Creditors arising out of Direct Insurance Operations	19	7,982	9,318	7,982	9,318
Other Creditors including Taxation & Social Security	20	20,220	25,035	19,851	24,029
Accruals and Deferred Income		1,767	3,449	1,576	2,968
		5,099,342	5,116,869	5,098,647	5,115,382

Approved by the Directors and signed on 31 March 2021 on their behalf by

- **DC Huntley**
  Chair
- **J Galbraith**
  Director and Chief Executive

The notes on pages 53 to 83 form an integral part of these accounts.

Notes to the Accounts

1. GENERAL INFORMATION

Scottish Friendly Assurance Society Limited ("Scottish Friendly") is an incorporated friendly society authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. It is incorporated in the United Kingdom, and its principal place of business is its registered office: Scottish Friendly House, 16 Blythswood Square, Glasgow, G2 4HJ.

It has six wholly owned subsidiaries, together "the Group". The principal activities of each company in the Group are detailed in the Directors' report.

2. ACCOUNTING POLICIES

Basis of preparation

The Accounts have been prepared in accordance with "The Financial Reporting Standard 102 ('FRS 102') and The Financial Reporting Standard 103 ('FRS 103')" being the applicable UK GAAP accounting standards. They have also been prepared in accordance with The Friendly Societies Act 1992 and The Friendly Societies (Accounts and Related Provisions) Regulations 1994.

The accounts have been prepared on a Going Concern basis, as confirmed in the Directors' Report. As outlined in the Directors' Report, after making enquiries, including consideration of the impact of Covid-19 on the Group's operations and financial position and prospects, the Directors believe that they have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future.

As a mutual life assurance society, under FRS 102, Scottish Friendly is exempt from the requirement to prepare a Statement of Cash Flow. The other companies in the Group are not entitled to this exemption on the basis that they are not mutual societies and therefore a Statement of Cash Flow has been disclosed in the individual accounts of each company.

The financial statements are prepared in sterling which is the functional currency of the Group and rounded to the nearest £000.

Basis of consolidation

The Group accounts consolidate the assets, liabilities and income and expenditure account transactions of Scottish Friendly together with its subsidiary undertakings. The ongoing results of subsidiary undertakings are included within Investment Income, Other Technical Income and Other Technical Charges. The net results are included in the Fund for Future Appropriations for the Group. The activities of Scottish Friendly and the Group are accounted for in the Income and Expenditure Technical Account – Long Term Business.

Contract classification

Scottish Friendly has carried out an analysis of its business to categorise its business as either insurance contracts (where the contracts meet the definition below) or as investment contracts.

A contract that exposes Scottish Friendly to financial risk without significant insurance risk is not an insurance contract – financial risk comprises market risks (e.g. investment returns, index prices, interest rates, etc.). Neither lapse, persistency nor expense risk is insurance risk as these do not impact the policyholder (so there is no risk transfer). Scottish Friendly has assessed 10% as the threshold for significant risk as an appropriate figure for its categorisation.

Scottish Friendly has carried out its assessment by considering homogenous product classes, rather than contract by contract, as each class has common product features including levels of insurance risk. The product range includes conventional and unitised with-profits business, unit- and index-linked business, and other non-profit business. Life product types include endowments, whole of life, and term assurance, as well as personal pensions accumulation and decumulation products, including annuities. Premiums may be regular or single.

This analysis has been carried out by assessing contracts at inception, including the investment fund where there is a unit linked or unitised with-profits option.

Significant judgements and estimates

Critical accounting judgements and key sources of estimation and uncertainty

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities and also makes critical accounting judgements in applying the Group's accounting policies.

Critical accounting judgments are those judgments, aside from those involving estimation (as detailed below), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Such estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable. The more critical areas, where accounting estimates and judgements are made, are set out below.

Critical accounting judgements

<u>Classification of long-term contracts</u>

The Group has exercised judgement in its classification of long-term business between insurance and investment contracts, which fall to be accounted for differently in accordance with the policies set out within our Accounting Policies. Insurance contracts are those where significant risk is transferred to the Group under the contract and judgement is applied in assessing whether the risk so transferred is significant.

Key sources of estimation and uncertainty

Key sources of estimation and uncertainty includes the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of the assets and liabilities within the next financial year.

<u>Insurance contracts liabilities</u>

Insurance contract liabilities are based on appropriate valuation assumptions. The evaluation of the Technical Provisions is the area of the accounts most reliant on judgement, assumptions about future experience and estimates. For with-profit insurance contracts these judgements impact the expected costs of meeting future guaranteed or discretionary benefits payable to policyholders. For non-profit contracts, these reserves are sensitive to changes in demographic and expense assumptions.

The cost of guarantee reserves balance is complex and material and is calculated using a stochastic model based on a variety of possible economic scenarios. Estimates have been made of the number of contract holders who will exercise these options, in order to measure their value. Changes in investment conditions could result in the cost of contract holders exercising their options being significantly higher than

Scottish Friendly has assumed in determining the liabilities arising from these contracts.

The valuation of the technical provision related to the protection business is also highly sensitive to the setting of the mortality and morbidity assumptions, which requires the application of significant judgement. Scottish Friendly makes estimates based on standard actuarial tables as appropriate, adjusted to reflect Scottish Friendly's own experience.

The Group makes estimates of future deaths, voluntary contract terminations, investment returns and administration expenses at the inception of long-term insurance contracts with fixed and guaranteed terms. These estimates, which are reassessed annually, form the assumptions used to calculate the liabilities arising from these contracts. The assumptions used to establish insurance contract liabilities and appropriate sensitivities relating to variations in critical assumptions are undertaken on a Solvency II basis.

Insurance claim reserves – reinsurance recoverable

A significant proportion of the insurance claims arising are ceded to reinsurers. The value placed on the associated reinsurance contracts are based on appropriate valuation assumptions, which are consistent with those used in the evaluation of the relevant insurance contract liabilities. The reinsurance asset is highly sensitive to assumptions around future mortality and morbidity experience, which are set based on observed experience and rely on judgements about how to interpret that experience and how that experience may change in the future.

In preparing the financial statements the Directors have made an assessment as to whether claims ceded to reinsurers are recoverable. As at 31 December 2020, such claims ceded to reinsurers and reflected on the balance sheet were £1,060k for insurance contract liabilities (31 December 2019: £983k) and £492k (31 December 2019: £539k) for investment liabilities. Any irrecoverability from these policies would flow through the surplus generated in the year.

Investments

The vast majority of investments held by Scottish Friendly are in collective investment schemes and are quoted in active markets. Investments represent Scottish Friendly's most significant asset balance £3.4bn at 31 December 2020 (£3.5bn at 31 December 2019) and are key to matching insurance liabilities.

However, there is estimation uncertainty in relation to £66m of investments in property funds, which are primarily open-ended and therefore carry a higher liquidity risk, and £27m of swaptions, which are complex derivative contracts that provide Scottish Friendly with an option to enter into an interest rate swap on the expiry date. The fair value of financial instruments that are not quoted in active markets are recorded as Level 2 or 3 and valued accordingly (see Note 9).

Valuation of financial assets and derivative financial investments

Wherever possible the fair value of financial assets and derivative financial investments are derived from active markets. In the absence of an active market fair value is estimated using valuation techniques that include the use of discounted cash flow models and/or mathematical models, the inputs to which are taken from observable data.

For discounted cash flow valuation, estimated future cash flows and discount rates are based on current market information and rates applicable to financial instruments with similar yields, credit quality and maturity characteristics. Note 9 contains more details on the valuation techniques applied.

Scottish Friendly holds derivative financial investments and these are disclosed in Note 9.

Valuation of insurance and investment contract liabilities

The liability calculations are undertaken on a Solvency II basis and are based on demographic and expense assumptions that reflect Scottish Friendly's best estimate of future experiences at the time of calculation. The economic assumptions used are market consistent, in line with the requirements of Solvency II, and are set using current market data.

For with-profits the underlying liabilities are based on "asset shares" and reflect the accumulated premiums, investment return, expenses and charges applied to each contract. Where appropriate, the cost of meeting future expected cash flows relating to the with-profits policies, including cash flows resulting from embedded options and guarantees, is evaluated using a stochastic approach. For non-profit contracts, the best estimate liability is calculated using a cash flow projection of all future benefit payments, future expenses and future premiums. These are adjusted for tax where applicable and discounted to give a present value. Credit is only taken for future premiums to the extent that they fall within the boundary of the contract, as defined under Solvency II.

The main assumptions used relate to mortality, morbidity, longevity, expenses, lapse and surrender rates, investment returns and discount rates. Scottish Friendly bases mortality, morbidity and longevity rates on standard industry or reinsurers' tables, adjusted where necessary to reflect Scottish Friendly's own experience. Expense, lapse and surrender rates assumptions are based on product characteristics and relevant claims experience. Investment returns and discount rates are based on current risk-free market rates, as prescribed under Solvency II.

Under deposit accounting, investment contract premiums and claims are not treated as income or expense and instead are treated as deposits which are received and paid directly to investment contract liabilities in the Balance Sheet. As there is no significant transfer of risk, these deposits are treated as fully under the trust of Scottish Friendly and are not required to be recognised in the Technical Account. Related investment contract charges and expenses are treated as profit or loss items within the Technical Account.

Valuation of pension benefit obligations

The valuation of the defined benefit pension scheme is determined using Actuarial valuations. The valuation includes assumptions about discount rates, expected returns on assets and mortality rates. The long-term nature of these obligations means the valuation is subject to significant uncertainty. Note 13 includes more details on the assumptions used.

Premiums

Insurance contracts

Gross regular premiums on insurance contracts are recognised when the policy liability is set up and the premium becomes due for payment; reinsurance premiums are accounted for when they come payable.

Investment contracts

Premiums relating to investment contracts are not recognised in the Technical Account but are recorded as contributions to and deductions from the investment contract liabilities recorded in the Balance Sheet.

Claims

Insurance contracts

Claims incurred, which include related claims handling expenses, are accounted for, in the case of death claims and surrenders, when they are notified to Scottish Friendly and, in the case of maturities and annuities, when they become due. Claims on participating business include bonuses payable. Reinsurance recoveries are credited to match the relevant gross amounts.

Investment contracts

Gross claims on non-participating investment contracts are deducted from investment contract liabilities and are accounted for as deductions from investments in the Balance Sheet.

Investment income and expenses

Investment income and expenses include dividends, interest, rents, gains and losses on the realisation of investments and the related expenses. Dividends are included as investment income on the date on which the shares are quoted "ex-dividend interests" and expenses are accounted for on an accruals basis. Realised gains and losses on investments are calculated as the difference between net sales proceeds and the original cost.

Unrealised investment gains and losses

Unrealised investment gains and losses are calculated as the difference between the valuation at the balance sheet date and the valuation at the last balance sheet date or purchase price, if acquired during the year. The movement in unrealised gains and losses recognised in the year also includes the reversal of unrealised gains and losses recognised in earlier years in respect of investment disposals in the current period. All unrealised gains and losses are included in the Technical Account.

Other technical income

Other technical income comprises fee income and, at Group level, the income of the subsidiaries. Fee income is charged to policyholders for administration services, investment management services and surrenders. These fees are recognised in the period over which the services are performed.

Taxation

The charge for taxation in respect of business that falls outside the tax-exempt limit is based on the rules for the taxation of friendly societies, as applied to items included in the Long-Term Business Technical Account for the year. It also takes into account deferred taxation arising from timing differences between the recognition of gains, losses and certain items of expenditure in the financial statements and recognition for tax purposes. Deferred tax assets are recognised to the extent that they are judged to be recoverable in future periods.

Acquisition costs

Acquisition costs comprise all direct and indirect costs arising from the conclusion of sales. The costs are not split between insurance and investment contracts because the business model manages the sales and marketing function on an integrated basis.

Financial investments

Upon initial recognition, financial investments are classified as either financial assets at fair value through profit or loss or loans and receivables.

Financial investments at fair value through profit or loss

The Group has elected to apply the recognition and measurement provisions of sections 11 and 12 of FRS102. Financial investments, including derivatives, are recognised at fair value through profit or loss. Scottish Friendly manages these investments and makes purchase and sale decisions based on their fair value in accordance with Scottish Friendly's investment strategy. Upon initial recognition, attributable transaction costs are recognised in profit or loss as incurred. Financial investments at fair value through profit or loss are measured at fair value and changes therein are recognised in profit or loss. Financial investments at fair value through profit or loss include derivatives, listed and unlisted investments, debt securities and bonds, and units in authorised unit trusts, Open Ended Investment Companies (OEICs) and other investments.

Derivatives

Derivatives, including swaptions, are not basic financial instruments. Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured at their fair value. Changes in the fair value of derivatives are recognised in profit or loss in finance costs or income as appropriate. The company does not currently apply hedge accounting for interest rate derivatives.

Land and buildings

Land and buildings occupied by Scottish Friendly are valued at fair value as determined in accordance with generally recognised methods of valuation. The aggregate unrealised surplus or deficit is included in the Technical Account. It is Scottish Friendly's practice to maintain these assets in a continual state of sound repair and to extend and make improvement thereto from time to time; accordingly, the Directors consider that the lives of these assets are so long and residual values, based on prices prevailing at the time of acquisition or subsequent valuation, are so high that any depreciation would be insignificant. Investments in Group undertakings are valued at fair value which is taken to be net asset value.

Directly held property is held for rental income and/or for capital appreciation, and is measured at fair value. Independent external valuers, having an appropriate recognised professional qualification and recent experience in the location and category of property being valued, undertake the valuation of the portfolio. The fair values reflect market values at the balance sheet date, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

Derecognition of financial investments

A financial asset is de-recognised when Scottish Friendly's right to receive cash flows from the asset has expired, and where Scottish Friendly has transferred to a third party its right to receive cash flow from an asset, or substantially all of the risks and rewardship of ownership or control of the asset.

Impairment of assets

Assets, other than those measured at fair value, are assessed for indicators of impairment; any impairment loss is recognised in profit and loss.

Claims outstanding

Claims outstanding represents the best estimate of the expected cashflows resulting from all outstanding obligations which have not as yet been paid to policyholders as at year end.

Tangible assets

Depreciation is provided so as to write off the cost less the estimated residual value of tangible assets by equal installments over the estimated useful economic lives as follows:

Computer Equipment	4 years
Fixtures & Fittings	10 years

Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and cash in hand as well as short-term deposits with a maturity of three months or less and known redemption values which are held to manage short-term operational cash requirements on origination.

Technical provisions

The technical provisions are determined in accordance with the requirements of the PRA rulebook: Solvency II Firm Technical Provisions Instrument 2015. They are calculated as the expected future cash flows (claims and expenses less premiums) plus a risk margin. The risk margin allows for the cost to a third party of holding the Solvency II capital until all contracts are settled.

Guarantees

Some participating contracts contain guarantees that can increase the benefits payable to the policyholder. A market consistent stochastic model is used to determine the potential liability for the following guarantees:

- the sum assured and declared reversionary bonuses on with-profits policies; and
- unitised with-profits plans containing guarantees that the market adjustments will not be applied at specific times.

Bonuses

Vested reversionary bonuses, including the current declaration, are dealt with in the Technical Account under "change in other technical provisions". Terminal bonuses paid during the year are included as part of claims incurred.

Foreign currencies

Transactions in foreign currencies are recorded at the average rate for the period. Monetary assets and liabilities denominated in foreign currencies are translated at the rate ruling at the balance sheet date. All differences are taken to the Technical Account.

Fund for Future Appropriations

The balance on this account represents funds that have not been allocated to specific policyholders. Transfers to and from the fund reflect the excess of income over outgoings in each accounting year arising from participating business.

Negative Goodwill

Negative goodwill occurs when the price paid for an acquisition is less than the fair value of the net assets required, where the transaction is considered to be a "business combination".

Where books of insurance business are transacted this relates to the benefits that the seller achieves through a combination of streamlining their business activity so that it is aligned to their overall strategy, benefits that are achieved from a regulatory capital perspective, and different expense assumptions.

This amount will be amortised over time as the capital requirements run-off and expected profits from this book emerge. This is estimated by the Directors to be over a 10 year period from inception.

Reinsurance

Reinsurance premiums payable are recognised when the underlying contract premiums become receivable or the underlying contract becomes effective. Reinsurance recoveries are recognised as a deduction to claims and are recognised when the underlying contract claims become payable.

Certain reinsurance assets that were acquired from Mobius Life and Canada Life are backed by investments in Collective Investment schemes and directly held property.

The underlying collective investment schemes are recognised at fair value through profit or loss.

3. EARNED PREMIUMS

Group and Scottish Friendly

Earned premiums, all of which relate to direct insurance on individual contracts, can be analysed as follows:

	Ordinary Assurance		Industrial Assurance		Total	
	2020 £000	2019 £000	2020 £000	2019 £000	2020 £000	2019 £000
Annual	143,197	121,275	843	745	144,040	122,020
Single	2,096	3,509	-	-	2,096	3,509
	145,293	124,784	843	745	146,136	125,529

Comprising		
Premiums for participating contracts	20,612	19,859
Premiums for non-participating contracts	114,559	98,625
Premiums from linked contracts	10,965	7,045
Gross Earned Premiums	146,136	125,529
Reinsurance Premiums on Insurance Contracts	(61,694)	(51,699)
Earned Premiums, net of reinsurance	84,442	73,830

Where policyholders have the option of investing premiums in either linked funds or accumulating With-Profits funds, these premiums are included above as premiums from linked contracts.

Gross new business premiums	Scottish Friendly 2020		Scottish Friendly 2019	
	Annual £000	Single £000	Annual £000	Single £000
New Business Premiums	40,354	16,350	36,441	13,800

Contributions received for Child Trust Funds, non-insurance ISAs and direct OEIC investments	Group		Scottish Friendly	
	2020 £000	2019 £000	2020 £000	2019 £000
Annual Contributions	2,410	2,442	-	-
Single Contributions	717	951	-	-

Contributions relate to business conducted by Scottish Friendly's subsidiary, Scottish Friendly Asset Managers Limited.

4. INVESTMENT INCOME

	Group		Scottish Friendly	
	2020 £000	2019 £000	2020 £000	2019 £000
Income from land & buildings	135	245	135	245
Income from financial investments held at fair value through profit and loss	64,136	27,487	64,136	27,487
Net realised gains on financial investments held at fair value through profit and loss	54,974	32,591	54,974	32,591
Investment Income	119,245	60,323	119,245	60,323

5. CLAIMS INCURRED

Group and Scottish Friendly

	Ordinary Assurance		Industrial Assurance		Total	
	2020 £000	2019 £000	2020 £000	2019 £000	2020 £000	2019 £000
Deaths	57,116	26,808	2,424	2,210	59,540	29,018
Maturities	64,536	55,720	314	274	64,850	55,994
Surrenders	35,307	29,021	1,178	1,637	36,485	30,658
Annuities	61,355	59,585	-	-	61,355	59,585
	218,314	171,134	3,916	4,121	222,230	175,255
Claims handling expenses					475	475
					222,705	175,730
Aggregate recoveries received from reinsurers					(90,010)	(80,987)
Net Claims Paid on Insurance Contracts					132,695	94,743

The above figures are stated after taking into account the movement in the provision for outstanding claims.

6. OPERATING EXPENSES

Group and Scottish Friendly

Operating Costs

There were no exceptional costs in 2020 (2019: nil)	2020 £000	2019 £000
Acquisition costs	14,080	17,314
Administration expenses	12,882	11,632
Information Technology Infrastructure	4,829	2,796
Renewal commission	30,433	24,224
	62,224	55,966

Remuneration of Auditors (included within administration expenses above)

	2020 £000	2019 £000
Fees payable to the auditor for audit of annual accounts	301	345
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	18	17
Other services pursuant to legislation	89	91
Other services	-	-

7. STAFF COSTS

Group and Scottish Friendly

Staff numbers and costs

The average number of persons, excluding Directors, employed by Scottish Friendly during the year was 204 (2019: 150). The aggregate payroll costs of these persons were as follows:

	2020 £000	2019 £000
Wages and salaries	7,525	6,249
Social security costs	696	599
Other pension costs	570	378
	8,791	7,226

Remuneration of Directors

Details of Directors' remuneration are included in the Directors' Remuneration Report on pages 39 to 40.

8. TAXATION

	Group		Scottish Friendly	
	2020 £000	**2019 £000**	**2020 £000**	**2019 £000**
Current tax charge	4,540	5,713	4,375	5,517
Deferred tax liabilities movement	(5,205)	5,437	(5,205)	5,437
Under/(Over) provided in earlier years	(1,361)	-	(1,361)	-
Other	(435)	-	(435)	-
Corporation Tax and irrecoverable income tax	(2,461)	11,150	(2,626)	10,954

UK corporation tax in the technical account has been calculated at a rate of 20% (2019: 20%) in accordance with rates applicable to the long term business of a friendly society.

	2020 £000	**2019 £000**
Transfer to fund for future appropriations	12,703	6,238
Income tax using the policyholder tax rate of 20%	2,541	1,248
Differences due to policyholder tax items	(3,806)	9,531
Under/(Over) provided in earlier years	(1,361)	175
Current tax year	(2,626)	10,954

The deferred tax liabilities expected to be settled after 12 months is £8.3m in the Group (2019: £13.6m) and £8.3m in Scottish Friendly (2019: £13.6m).

Corporation tax is charged at the standard rate of 19% on the profit on ordinary activities of the subsidiary SFAM £166,000 (2019: £188,000) with adjustments in respect of prior year's being £nil (2019:nil).

9. FINANCIAL INVESTMENTS

	Group				Scottish Friendly			
	Carrying Value		Cost		Carrying Value		Cost	
	2020 £000	2019 £000	2020 £000	2019 £000	2020 £000	2019 £000	2020 £000	2019 £000
Non-linked and linked financial investments								
Non-linked financial investments	1,178,887	1,200,925	1,006,107	1,032,010	1,182,500	1,204,094	1,008,925	1,034,846
Linked financial investments	2,230,570	2,309,535	1,926,031	2,047,538	2,230,570	2,309,535	1,926,031	2,047,538
Total financial investments	3,409,457	3,510,460	2,932,138	3,079,548	3,413,070	3,513,629	2,934,956	3,082,384
of which financial investments designated as:								
a) Financial investments designated at fair value	3,150,940	3,281,395	2,710,138	2,854,740	3,154,553	3,284,564	2,712,956	2,857,576
(b) Derivatives	27,253	25,218	24,201	27,141	27,253	25,218	24,201	27,141
(c) Loans and receivables	231,264	203,847	197,799	197,667	231,264	203,847	197,799	197,667
Total financial investments	3,409,457	3,510,460	2,932,138	3,079,548	3,413,070	3,513,629	2,934,956	3,082,384
Non-linked financial investments								
(a) Financial investments designated at fair value; Shares, other variable yield securities and units in OEICs and unit trusts	625,726	658,618	480,401	484,090	625,429	658,339	480,104	483,811
Debt securities and other fixed income securities	326,090	324,601	313,443	332,849	326,090	324,601	313,443	332,849
Private equity investments	72	81	658	658	72	81	658	658
Investments in Group Undertakings	-	-	-	-	3,910	3,448	3,115	3,115
Land and buildings	3,500	3,500	3,325	3,325	3,500	3,500	3,325	3,325
	955,388	986,800	797,827	820,922	959,001	989,969	800,645	823,758
(b) Derivatives								
Derivative Assets	27,253	25,218	24,200	27,141	27,253	25,218	24,200	27,141
(c) Loans and receivables								
Deposits with credit institutions	196,246	188,907	184,080	183,947	196,246	188,907	184,080	183,947
Total non-linked financial investments	1,178,887	1,200,925	1,006,107	1,032,010	1,182,500	1,204,094	1,008,925	1,034,846
Linked financial investments								
(a) Financial investments designated at fair value; Shares, other variable yield securities and units in OEICs and unit trusts	2,195,388	2,293,987	1,911,990	2,033,111	2,195,388	2,293,987	1,911,990	2,033,111
Debt securities and other fixed income securities	164	453	321	552	164	453	321	552
Land and Buildings	-	155	-	155	-	155	-	155
	2,195,552	2,294,595	1,912,311	2,033,818	2,195,552	2,294,595	1,912,311	2,033,818
(b) Derivatives								
Derivative Assets	-	-	-	-	-	-	-	-
(c) Loans and receivables								
Deposits with credit institutions	35,018	14,940	13,720	13,720	35,018	14,940	13,720	13,720
Total linked financial investments	2,230,570	2,309,535	1,926,031	2,047,538	2,230,570	2,309,535	1,926,031	2,047,538
Total Financial Investments	3,409,457	3,510,460	2,932,138	3,079,548	3,413,070	3,513,629	2,934,956	3,082,384

9. FINANCIAL INVESTMENTS (continued)

Scottish Friendly applies the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

Level 1: unadjusted prices quoted in active markets for identical assets or liabilities.

Prices are obtained from pricing service providers where there is clear evidence that the valuations are based on traded prices in an active market. The prices for assets in this category are received daily from Thomson Reuters, or are provided by third parties based on active market prices.

Level 2: inputs other than quoted prices that are observable either directly (as prices) or indirectly (as derived from prices).

Where it is not possible to determine prices based on actual transactions in an active market, the fair value is based on broker quotes and information from fund managers. Assets in this category include the investment property held by Scottish Friendly and derivatives.

Level 3: the inputs are not based on observable market data (unobservable inputs).

In a minority of cases, there are no market observable inputs and therefore the fair value is determined using a valuation technique based on assumptions that are not supported by observable market transactions nor based on market data. Such assets include Scottish Friendly's investment in private equity funds and the subsidiary companies.

Each financial instrument is categorised according to the lowest level of input that is significant to the fair value measurement of the financial instrument. Both price volatility and market information on assets are reviewed periodically to see if there is any indicator that an asset may require classification due to liquidity or impairment.

Fair Value Hierarchy	Group				Scottish Friendly			
	Level 1 £000	Level 2 £000	Level 3 £000	Total £000	Level 1 £000	Level 2 £000	Level 3 £000	Total £000
Financial instrument assets 2020								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts*	2,733,760	87,354	-	2,821,114	2,733,462	87,355	-	2,820,817
Debt securities and other fixed income securities	286,490	35,465	4,299	326,254	286,490	35,465	4,299	326,254
Private equity investments	-	-	72	72	-	-	72	72
Investments in Group Undertakings	-	-	-	-	-	-	3,910	3,910
Land and buildings	-	3,500	-	3,500	-	3,500	-	3,500
	3,020,250	126,319	4,371	3,150,940	3,019,952	126,320	8,281	3,154,553
Derivative assets	-	27,253	-	27,253	-	27,253	-	27,253
Financial assets measured at fair value through profit and loss	3,020,250	153,572	4,731	3,178,193	3,019,952	153,573	8,281	3,181,806
Loans and receivables;								
Deposits with credit institutions	230,977	287	-	231,264	230,977	287	-	231,264
	230,977	287	-	231,264	230,977	287	-	231,264
Total financial assets	-	-	-	3,409,457	-	-	-	3,413,070
Financial instrument liabilities 2020								
Investment contract and liabilities (see Note 11)				2,753,862				2,753,862
				2,753,862				2,753,862

9. FINANCIAL INVESTMENTS (continued)

We note that at the year end Scottish Friendly had an investment in the M&G Property Fund (Level 2 assets), which is presently suspended. The price is not considered to be a stale price, and therefore the valuation is considered to be appropriate by the Directors. The suspension of this Fund had no impact on the liquidity of the MGM unit holders at the year end. In addition, we note that at the year end Scottish Friendly had an investment in a Level 3 security that has subsequently become the subject of a potential class action.

	Group				Scottish Friendly			
	Level 1 £000	Level 2 £000	Level 3 £000	Total £000	Level 1 £000	Level 2 £000	Level 3 £000	Total £000
Financial instrument assets 2019								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	2,883,259	69,346	-	2,952,605	2,882,980	69,346	-	2,952,326
Debt securities and other fixed income securities	282,559	38,454	4,041	325,054	282,559	38,454	4,041	325,054
Private equity investments	-	-	81	81	-	-	81	81
Investments in Group Undertakings	-	-	-	-	-	-	3,448	3,448
Land and buildings	-	3,655	-	3,655	-	3,655	-	3,655
	3,165,818	111,455	4,122	3,281,395	3,165,539	111,455	7,570	3,284,564
Derivative assets	-	25,218	-	25,218	-	25,218	-	25,218
Financial assets measured at fair value through profit and loss	3,165,818	136,673	4,122	3,306,613	3,181,659	120,544	7,570	3,309,782
Loans and receivables;								
Deposits with credit institutions	203,560	287	-	203,847	203,560	287	-	203,847
	203,560	287	-	203,847	203,560	287	-	203,847
Total financial assets				3,510,460				3,513,629
Financial instrument liabilities 2019								
Investment contract liabilities				2,832,589				2,832,589
				2,832,589				2,832,589

Financial instruments have been categorised between Levels 1, 2 or 3 for the fair value hierarchy on a consistent basis between 2019 and 2020. There have been no changes to the valuation methods of Levels 1, 2 or 3 in 2020 and no change in the nature of the financial instruments. All changes in fair value of financial instruments have resulted directly from trading in 2020 and market movement. On this basis, no reconciliation for movements between Level 1, 2 and 3 is required.

Derivative contracts

Scottish Friendly has the following derivative contract balances measured as fair value through profit or loss:

	2020 £m	2019 £m
Derivative assets	27	25

9. FINANCIAL INVESTMENTS (continued)

Derivative financial instruments

Scottish Friendly holds interest rate swaptions to mitigate the interest rate risk associated certain contractual options on its unit linked business. At 31 December 2020, the outstanding contracts all mature within 7 years of the year end.

The interest rate swaptions are measured at fair value, which is determined using valuation techniques that utilise observable inputs. The key assumptions used in valuing the derivatives are interest rate curve data and interest rate volatility data.

10. TANGIBLE ASSETS

Group and Scottish Friendly

	Computer equipment £000	Fixtures & fittings £000	Total £000
Cost			
At 1 January 2020	650	216	866
Additions	217	250	467
Disposals	-	-	-
At 31 December 2020	**867**	**466**	**1,333**
Depreciation			
At 1 January 2020	323	32	355
Charge for the year	103	22	125
Disposals	-	-	-
At 31 December 2020	**426**	**54**	**480**
Net Book Value at 31 December 2020	**441**	**412**	**853**
Net Book Value at 31 December 2019	327	184	511

11. TECHNICAL PROVISIONS

Group and Scottish Friendly

A breakdown of technical provisions on a gross and net basis is shown below.

Analysis of contract liabilities gross and net of reinsurance	2020			2019		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
With-Profits Insurance	816,030	(404,947)	411,083	872,042	(426,307)	445,735
Non-Profits Insurance	925,924	(654,878)	271,046	803,899	(557,805)	246,094
Unit Linked Insurance	296,912	-	296,912	316,968	-	316,968
Investment Contracts	2,753,862	(491,502)	2,262,360	2,832,589	(539,441)	2,293,148
Total	4,792,728	(1,551,327)	3,241,401	4,825,498	(1,523,553)	3,301,945

11. TECHNICAL PROVISIONS (continued)

The movements on the technical provisions during the year are as follows:

With-Profits Insurance Contracts	Gross 2020 £000	Reinsured 2020 £000	Gross 2019 £000	Reinsured 2019 £000
1 January	872,042	(426,301)	728,859	(398,516)
Premiums received	20,612	(24)	19,859	(17)
Liabilities paid by claims	(100,059)	49,120	(99,358)	49,365
New Business	1,163	-	861	-
Transfer of Engagement	-	-	147,763	-
Experience variance and assumption changes	22,272	(27,742)	74,058	(77,139)
31 December	816,030	(404,947)	872,042	(426,307)

Non-Profit Insurance Contracts	Gross 2020 £000	Reinsured 2020 £000	Gross 2019 £000	Reinsured 2019 £000
1 January	803,899	(557,805)	566,628	(498,256)
Premiums received	114,559	(61,670)	98,625	(51,682)
Liabilities paid by claims	(83,912)	40,890	(50,846)	31,622
New Business	63,164	(60,738)	12,193	(11,125)
Transfer of Engagement	-	-	280,106	(14,631)
Experience variance and assumption changes	28,214	(15,555)	(102,807)	(13,733)
31 December	925,924	(654,878)	803,899	(557,805)

Unit Linked Insurance Contracts

	Gross 2020 £000	Reinsured 2020 £000	Gross 2019 £000	Reinsured 2019 £000
1 January	316,968	-	102,028	-
Premiums received	10,965	-	7,045	-
Liabilities paid by claims	(38,259)	-	(25,050)	-
New Business	-	-	-	-
Fees deducted	(3,385)	-	(1,918)	-
Transfer of Engagement	-	-	178,458	-
Change in investment value of contracts	10,623	-	56,405	-
31 December	296,912	-	316,968	-

11. TECHNICAL PROVISIONS (continued)

Investment Contracts

	Gross 2020 £000	Reinsured 2020 £000	Gross 2019 £000	Reinsured 2019 £000
1 January	2,832,589	(539,441)	942,215	(302,377)
Premiums received	50,967	(3,263)	43,581	(6,967)
Liabilities paid by claims	(185,769)	20,477	(89,952)	23,958
New Business	12,462	137	8,011	194
Fees deducted	(33,453)	-	(11,756)	-
Transfer of Engagement	-	-	1,702,102	(218,113)
Change in investment value of contracts	77,066	30,588	238,388	(36,136)
31 December	2,753,862	(491,502)	2,832,589	(539,441)

The investment contract technical provisions above show the position after allowing for the positive contribution made of the value of the in-force business to the business. Excluding this would increase the liability by the amounts shown below, with the creation of an equal and opposite asset on the balance sheet.

Technical Provisions (Excluding Value In Force)	2,761,319	(491,502)	2,845,279	(539,441)
Value of in-force business	(7,457)	-	(12,690)	-
Technical Provisions	2,753,862	(491,502)	2,832,589	(539,411)

12. COSTS OF BONUSES

Group and Scottish Friendly

Total bonuses attributable to the year are as follows:	2020 £000	2019 £000
Year end reversionary bonus declared (included in change in other technical provisions)	2,604	3,247
Reversionary and terminal bonuses paid (included in claims)	9,474	12,434
	12,078	15,681

13. PENSIONS

Group and Scottish Friendly

Money purchase Group personal pension scheme

Scottish Friendly operates a money purchase Group personal pension scheme. For the year ended 31 December 2020, the charge included in the Technical Account relating to the employer's contributions to this scheme was £590,000 (2019: £398,000). There were no outstanding or prepaid contributions at the date of the Balance Sheet.

MGM Assurance Staff Pension Plan

Scottish Friendly sponsors the MGM Assurance Staff Pension Plan, a funded defined benefit pension plan in the UK. The Plan is set up on a tax relieved basis as a separate trust independent of Scottish Friendly.

13. PENSIONS (continued)

The Trustees are responsible for ensuring that the correct benefits are paid, that the Plan is appropriately funded and that Plan assets are appropriately invested. Scottish Friendly pays the balance of the cost as determined by regular actuarial valuations. The Trustees are required to use prudent assumptions to value the liabilities and costs of the Plan whereas the accounting assumptions must be best estimates. Under the current Recovery Plan, dated 6 September 2019, Scottish Friendly is paying contributions of £226,667 per month for a period of 2 years and 9 months from 1 October 2019 to 30 June 2022.

A formal actuarial valuation was carried out as at 31 December 2018. The liabilities at the reporting date have been calculated by using the same membership data as that used for the 2018 actuarial valuation, but adjusted to allow for the passage of time, benefits paid out of the Plan and changes in actuarial assumptions over the period from 31 December 2018 to 31 December 2020. The figures in the following disclosure were measured using the Projected Unit Method.

The amounts recognised in the statement of financial position are as follows:	2020 £000	2019 £000
Defined benefit obligation	(121,232)	(110,167)
Fair value of plan assets	141,917	120,608
Net defined benefit asset	20,685	10,441
Restriction on asset recognised	-	-
Net amount recognised at year end (before any adjustment for deferred tax)	20,685	10,441

The amounts recognised in comprehensive income are:

The current and past service costs, settlements and curtailments, together with the net interest expense for the year as included in profit or loss. Remeasurements of the net defined benefit liability are included in other comprehensive income.

	2020 £000	2019 £000
Service cost:		
Current service cost (net of employee contributions)	-	-
Administration expenses	-	-
Loss/(gain) on plan introductions, changes, curtailments and settlements	56	-
Net interest expense/(credit)	(242)	(324)
Charge/(credit) recognised in profit of loss	(186)	(324)
Remeasurements of the net liability:		
Return on Plan assets (excluding amount included in net interest expense)	(18,794)	(10,786)
Actuarial (losses)/gains	11,456	13,594
Adjustment for the restrictions on the asset recognised	-	-
Charge/(credit) recorded in other comprehensive income	(7,338)	2,808
Total defined benefit cost/(credit)	(7,524)	2,484

13. PENSIONS (continued)

The principal actuarial assumptions used were:

	2020	2019
Liability discount rate	1.25%	2.05%
Inflation assumption – RPI	3.05%	3.15%
Inflation assumption – CPI	2.30%	2.15%
Revaluation of deferred pensions:		
GMP	Fixed rate	Fixed rate
Excess over GMP	2.30%	2.15%
Increases for pensions in payment:		
Pre 88 GMP	0.00%	0.00%
Post 88 GMP	3.00%	3.00%
Excess over GMP (RPI capped at 5%)	3.00%	3.05%
Proportion of employees opting for early retirement	0%	0%
Proportion of pension commuted for cash at retirement	20%	0%
Expected age at death of current pensioner at age 65:		
Male aged 65 at year end:	88.1	88.3
Female aged 65 at year end:	90.3	90.4
Expected age at death of future pensioner at age 65:		
Male aged 45 at year end:	89.8	90.0
Female aged 45 at year end:	91.5	91.6

Analysis has been carried out over 2020 into the proportion of employees commuting their pension for cash. Reflective of this new information, an assumption that 20% of pension benefit is commuted to cash (2019: 0%) has been allowed for in the amounts recognised in the statement of financial position.

Reconciliation of Plan assets and liabilities	Assets £000	Liabilities £000	Total £000
At start of period	120,608	(110,167)	10,441
Benefits paid	(2,678)	2,678	-
Administration expenses	-	-	-
Current service cost	-	-	-
Contributions from the employer	2,720	-	2,720
Contributions from employees	-	-	-
Interest income/(expense)	2,473	(2,231)	242
Return on assets (excluding amount included in net interest expense)	18,794	-	18,794
Actuarial gains/(losses)	-	(11,456)	(11,456)
Past service cost	-	(56)	(56)
Gain/(loss) on curtailments	-	-	-
Assets distributed/liabilities extinguished on settlements	-	-	-
Assets acquired/liabilities assumed in a business combination	-	-	-
At end of period	141,917	(121,232)	20,685

The return on Plan assets was:

	2020 £000	2019 £000
Interest income	2,473	2,998
Return on plan assets (excluding amount included in net interest expense)	18,794	10,786
Total return on plan assets	21,267	13,784

13. PENSIONS (continued)

The major categories of Plan assets are as follows:

	2020 £000	2019 £000
UK Equities	2,796	3,077
Overseas Equities	10,337	14,605
Corporate Bonds	11,009	11,050
Gilts	17,502	12,694
Index Linked	6,633	5,021
Property	3,535	3,903
Commodities	2,674	1,980
Hedge Funds/Diversified Growth Funds	8,439	15,493
Cash	26,257	11,833
LDI	41,230	30,663
Alternatives	11,505	10,289
Total market value of assets	141,917	120,609

Projected P&L cost items for year ending:	2021 £000	2020 £000
Service cost - inc. current & past service costs, settlements	-	56
Service cost - administrative cost	-	-
Net interest on the net defined benefit liability	(276)	(242)
	(276)	(186)

If the discount rate was 0.5 percent higher (lower), the Fund liabilities would decrease by £11,727k (increase by £13,618k) if all the other assumptions remained unchanged.

If the inflation assumption was 0.5 percent higher (lower), the Fund liabilities would increase by £9,841k (decrease by £9,423k). In this calculation all assumptions related to the inflation assumption have been appropriately adjusted, that is the deferred pension increases and pension in payment increases, if all the other assumptions remain unchanged.

If life expectancies were to increase by 1 year, the Fund liabilities would increase by £6,499k if all the other assumptions remained unchanged.

14. WITH-PROFITS ACTUARY

Group and Scottish Friendly

Mr S Makin of Hymans Robertson LLP served as the With-Profits Actuary for the period between 1 January 2020 and 31 December 2020. The following information has been provided in response to a request made by Scottish Friendly as required by section 77 of the Friendly Societies Act 1992. Mr Makin has confirmed that neither he nor his family were members of Scottish Friendly, nor had they any financial or pecuniary interest in Scottish Friendly, with the exception of fees paid to Hymans Robertson LLP for professional services which amounted to £429,299 (this figure includes fees payable for work carried out by Hymans Robertson LLP not related to Mr Makin's role as With-Profits Actuary).

15. TRANSACTIONS WITH RELATED PARTIES

Group and Scottish Friendly

The aggregate premiums payable for the year by nine Directors in respect of Scottish Friendly's products amounted to £70,321 (2019: £51,328).

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

16.CAPITAL MANAGEMENT (UNAUDITED)

Group and Scottish Friendly

(a) Capital management policies and objectives

Scottish Friendly's capital management objectives are:

- to protect Scottish Friendly's financial strength, providing security to policyholders;
- to comply with the PRA's capital requirements; Scottish Friendly has not breached these requirements at any point in the current or prior years;
- to enable smoothing of investment returns and payouts; and
- to ensure that Scottish Friendly's capital position is sufficient to enable it to invest in the development of the business in order to fulfil its stated core strategic objectives as determined by the Board.

The capital position of Scottish Friendly is monitored on a regular basis and reviewed formally by the Board.

(b) Solvency II balance sheet

A Solvency II available capital balance sheet is shown below, split between the Main Fund, which is open to new business, and its sub-funds that are closed. The closed subfunds are the Rational Shelley sub-fund, LANMAS (London Aberdeen and Northern Mutual Assurance Society) sub-fund, the Scottish Legal sub-fund, the M&GM sub-fund and the Manulife sub-fund.

Solvency II available capital for both the open and closed funds of Scottish Friendly is determined in accordance with the Solvency II balance sheet methodology. This can be broadly described as placing a fair value on both the assets and participating liabilities, including both benefits already guaranteed and future discretionary benefits.

Participating liabilities comprise asset shares, plus the costs of smoothing, and the value of guarantees and options which have been granted to policyholders plus a best estimate of the liabilities on the non-profit business. The asset share represents the premiums received to date, together with investment return earned, less expenses and charges and an allowance for any withdrawals.

There are two principal types of financial option and guarantee:

- guaranteed lump sum payments due on specified dates. These mainly comprise the sum assured together with annual bonuses added onto participating contracts. Although Scottish Friendly invests in a reasonably broad range of asset types, there is still a risk that assets held to back any individual policy (the asset share) may be depressed at the time that the guaranteed payment due at maturity falls to be paid. The potential cost of honoring these guarantees is quantified as part of the liability for participating contracts; and
- guaranteed income guarantees. These primarily arise in connection with pension business and occur in one of two forms:
  - a guaranteed income specified in the contract; and
  - guaranteed terms for converting lump sum maturity benefits into an income at maturity.

When calculating the participating liabilities, allowance has been made for actions that management would be expected to undertake on key assumptions, for example future bonus or investment policy in varying market conditions, in line with the PPFMs (Principles and Practices of Financial Management). The cost of financial options and guarantees are measured using a market-consistent stochastic model.

(c) Capital Statement (unaudited)

Available capital resources

	2020			2019		
	Main fund £000	Closed sub-funds £000	Total £000	Main fund £000	Closed sub-funds £000	Total £000
Total available capital resources	130,857	32,755	163,612	129,890	38,948	168,838

The capital resources in 2020 are calculated under the Solvency II regulatory requirements and the total capital resources presented represents Solvency II own funds. The Solvency II capital positions are presently unaudited.

(d) Movement in available capital resources (unaudited)

	2020 £000	2019 £000
Opening capital resources	168,838	110,743
Prior year adjustments	-	27
Increase/(Decrease) in Current Assets	(54,539)	2,211,164
(Increase)/Decrease in Technical Provisions	54,457	(2,165,369)
(Increase)/Decrease in Current Liabilities	(3,328)	18,543
Total	165,428	175,108
(Decrease) in ring-fencing of available capital	(1,816)	(6,270)
Closing capital resources	163,612	168,838

Note: the opening capital resources are consistent with those shown in the report and accounts as at 31 December 2020. At the point of reporting, the position was unaudited and a small adjustment was made as part of the finalisation. This has led to the prior year adjustment shown.

(e) Solvency position

	2020 £000	2019 £000
Own Funds	163,612	168,838
SCR	101,112	99,853
Solvency Ratio	162%	169%

(f) Capital resource sensitivities

The capital position is sensitive to changes in market conditions and to a lesser extent to assumptions and experience relating to mortality, expenses and persistency.

Economic assumptions are set consistent with market prices. The liability valuation will include assumptions about interest rates and investment returns. An adverse change in either variable will increase liabilities and, to the extent that assets are impacted, this may increase or decrease the available capital. For example, a reduction in long-term interest rates would increase the amount of Scottish Friendly's liabilities and could therefore reduce its available capital, depending upon the extent to which the liabilities are matched by assets with similar anticipated cash flows. Currently, the available capital of Scottish Friendly will decrease if interest rates fall.

Similarly, an adverse change in the markets for Scottish Friendly's investment assets could increase or decrease the available capital of Scottish Friendly to the extent that equity falls cannot be reflected in reductions in payments to policyholders because of the presence of guarantees and options in the underlying contracts, and any change in assets within the working capital. Currently, a fall in equity/property values would reduce available capital for the Scottish Friendly main fund.

Non-economic assumptions are set at best estimate levels based on historic experience. Scottish Friendly monitors actual experience in mortality; morbidity and persistency rates against the assumptions used, and applies that outcome to refine its long-term assumptions. Amounts paid will inevitably differ from estimates, particularly when the expected payments do not occur until well into the future. Liabilities are evaluated at least quarterly, allowing for changes in the assumptions used, as well as for the actual claims experience. If actual claims experience is less favourable than the underlying assumptions, or it is necessary to increase provisions in anticipation of a higher rate of future claims, then available capital will be reduced.

Scottish Friendly has provided guarantees in respect of sums assured and reversionary bonus guarantees on with-profits contracts. Under the Solvency II balance sheet basis, these are explicitly calculated using a stochastic valuation model.

17. DEPOSITS RECEIVED FROM REINSURERS

The "Standard" and "Select" annuity products written in the past by M&GM are reinsured under treaties with Pacific Life Re and Hannover respectively, with an overlay treaty with RGA providing 100% reinsurance in total.

The reinsurance treaties include appropriate collateral arrangements, including the following deposits with Scottish Friendly as collateral security for their liabilities and obligations under the contracts.

	2020 £000	2019 £000
Collateral deposits for:		
"Select" annuity (Hannover Re)	34,378	36,598
"Standard" annuity (RGA)	6,172	5,835
	40,550	42,433

18. DEPOSITS HELD FOR REINSURERS

The "Standard" and "Select" annuity products written in the past under treaties with PacLife and Hannover respectively, with an overlay treaty with RGA providing 100% reinsurance in total.

The reinsurance treaties include appropriate collateral arrangements, in deposits with Scottish Friendly as collateral security for their liabilities and obligations under the contracts.

	2020 £000	2019 £000
Collateral deposits for:		
Longevity Swap (Pacific Life Re)	9,398	7,975
	9,398	7,975

19. CREDITORS ARISING OUT OF DIRECT INSURANCE OPERATIONS

Group and Scottish Friendly

	2020 £000	2019 £000
Due to reinsurers	1,971	2,345
Due to intermediaries	6,011	6,973
	7,982	9,318

20. OTHER CREDITORS INCLUDING TAXATION AND SOCIAL SECURITY

	Group		Scottish Friendly	
	2020 £000	2019 £000	2020 £000	2019 £000
Taxation	12,824	19,909	12,719	19,843
Trade Creditors	1,450	132	1,450	132
Investments Creditors	2,202	102	2,202	102
Other payables	2,710	2,980	2,446	2,040
HMRC payments PAYE and VAT	1,034	1,912	1,034	1,912
	20,220	25,035	19,851	24,029

21. RISK MANAGEMENT

The principal risks to which Scottish Friendly is exposed are strategic, solvency, liquidity, operational, reputation and conduct risks as well as cyber-crime. Scottish Friendly's approach to risk management is detailed in the Report on Corporate Governance on pages 24 to 38, with a description of the key aspects, controls and risk mitigation details in relation to the principal risks to which Scottish Friendly is exposed.

This has included an assessment of the impact of a range of adverse scenarios on Scottish Friendly, including consideration of the potential impact of climate change on the business over the coming years and the potential implications of no deal Brexit being reached by the UK Government and EU by the end of the transition period. Other than the fact that no deal could impact the investment markets to which our results are sensitive, we consider that our operating model is relatively unaffected by a no deal Brexit scenario.

Further details are included here of insurance risk, credit risk and liquidity risk, and a sensitivity analysis of each type of market risk.

Insurance risk refers to the fluctuations in the timing, frequency and severity of insured events, and the expense of administering the in-force business relative to the expectations of Scottish Friendly at the inception of the contract. The exposure of Scottish Friendly depends on the value of claims to be paid in the future, relative to the assets accumulated to the date of claim. The amount of such future obligations is assessed by reference to assumptions with regard to future mortality and/or morbidity rates, persistency rates, expenses, investment returns, interest rates and tax rates.

The Board, having taken advice from the Head of Actuarial, may set limits on business volumes, including the maximum volumes of specific products with particular risks based on its risk appetite. The risks are monitored by the Risk function.

The level of insurance risk assumed by Scottish Friendly varies with the type of business written. Additional risks also arise from the financial options and guarantees within contracts.

With-profits contracts

With-profits contracts (including both conventional and unitised with-profits policies) usually contain a guaranteed benefit on maturity, death or surrender at certain specified dates.

This guaranteed benefit may be increased by the addition of annual bonuses and a final bonus may also be applied when the policy becomes a claim. Scottish Friendly can vary the amount of future bonuses paid, including reducing future bonus additions to zero. Scottish Friendly also has contractual discretion to vary the amount payable on early surrender of the contract. The setting of bonus rates and surrender terms are subject to the relevant PPFM. All discretionary actions must be consistent with the overriding principle that customers be treated fairly.

The key risk factors of with-profits contracts are:

- **mortality**:
  The guaranteed payments on death generally exceed the value of the assets held to back the policy, giving rise to mortality risk. Assumptions regarding the rate of mortality are taken into account when determining the bonus payments to be added to with-profits contracts. The level of these bonus additions can be varied to mitigate differences between expected and actual mortality experience.
- **guarantees**:
  With-profits contracts are subject to the risk that the market value of assets held to back the liabilities is depressed at the time that the guaranteed payments specified in the contract fall due to be paid. Scottish Friendly's contractual right to vary future bonus additions can mitigate this risk.
- **persistency and expenses:**
  The most significant costs associated with writing insurance contracts are the costs incurred to acquire the policy. These expenses, together with the ongoing costs of administration, are recovered over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. For some product types, this risk is mitigated by Scottish Friendly's contractual ability to vary the amount payable on surrender. Scottish Friendly also controls its administration expenses on an ongoing basis, and Scottish Friendly's right to vary future bonus additions can be used to mitigate this risk.

Protection contracts

Protection policies contain a guaranteed payment on death or disability or illness depending on the terms of the contract. These contracts may also be attached to with-profits or unit linked policies. In addition, Scottish Friendly transferred a small number of income protection policies from Canada Life Limited, which pay policyholders a defined income when they are unable to work due to sickness for an extended period of time. For most policies, the level of benefits payable is determined at the start of the contract and hence the ability of Scottish Friendly to reduce the level of insurance risk accepted by varying terms and conditions may be limited. However, many contracts include a premium review clause and for some contracts the policyholder has the option to reduce benefits in lieu of a premium increase.

The key insurance risk factors of protection contracts are:

- **mortality and morbidity**:
  Scottish Friendly has largely mitigated these risks through the use of reinsurance to transfer most of the mortality and morbidity risk to third-party reinsurers.
- **persistency and expenses**:
  Scottish Friendly manages these risks by monitoring persistency experience, including through discussions with our partners and actively controlling and monitoring expense levels.

Non-participating insurance contracts – non-profit annuities

For non-profit annuities, the level of annuity payments is determined at the start of the contract and these payments continue until the death of the annuitant and in certain cases the later death of their dependants. Hence the ability of Scottish Friendly to reduce the level of insurance risk accepted by varying terms and conditions is limited.

The key insurance risk factors of annuity contracts are:

- **longevity**:
  The contractual stream of payments made until the death of the annuitant gives rise to longevity risk. An increase in life expectancy will increase the payments that have to be made. Scottish Friendly has mitigated this risk by the extensive use of third-party reinsurers.

Non-participating investment contracts – unit linked policies

For unit linked investment business most of the risks (particularly market and credit risk) are borne by the policyholders. The principal benefit payable is the value of the underlying assets and therefore Scottish Friendly generally has limited ability to apply penalties on early surrender or early cessation of regular premiums. The ability to increase charges or apply penalties may be constrained by regulatory or market pressures and by the obligation to treat customers fairly.

The key insurance risk factors of unit linked contracts are:

- **persistency and expenses**: Acquisition and administration costs are recovered by management charges deducted over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. Expenses may also exceed expense deductions for continuing policies. These risks are mitigated by Scottish Friendly's ability to increase charges or in some instances to apply penalties on early surrender. Scottish Friendly also controls its administration expenses on an ongoing basis.
- **embedded guarantees**: A small number of the unit linked contracts transferred from Canada Life Limited include guarantees relating to the minimum level of income that can be purchased at retirement using the proceeds of the policy or guarantees related to the terms of that purchase. These risks are mitigated by Scottish Friendly's use of appropriate investment strategies that match changes in the value of these liabilities under market movements.

Insurance risk sensitivity analysis:

The following table illustrates the impacts on the Scottish Friendly Main Fund of applying stress scenarios prescribed under the Solvency II regulations, which are believed to be good approximations of the sensitivities under UK GAAP.

	2020 Impact on the FFA £m	2019 Impact on the FFA £m
Increase in expenses by 10%	(16.0)	(13.5)
Increase in assurance mortality rates by 15%	(3.7)	(2.5)
Reduction in persistency by 10%	(11.4)	(6.0)

For the purposes of the scenarios shown above, it has been assumed that the negative goodwill recognised in respect of the transfer from Canada Life Limited would be written down to absorb the impact of the scenario, adjusted as appropriate to allow for amortisation at that point.

Credit risk

Credit risk is the risk of loss arising in the event of the failure of third parties to meet their financial obligations in a timely manner. Scottish Friendly's key exposures relate to holdings in corporate bonds, cash deposits, and defaults in reinsurers and key counterparties. Scottish Friendly manages this risk by setting clear limits and tolerances on exposures to a single counterparty, or groups of counterparties, holding treaties with several different reinsurers and using only reinsurers with appropriate credit ratings.

The potential financial exposure is in the table on page 80, showing the assets of the Group and Scottish Friendly that are subject to credit risk and the Balance Sheet carrying value for that asset. For derivatives the credit rating reflects the credit rating of the counterparty. Linked assets are not subject to credit risk as this risk is borne by the holders of the contracts concerned. The Board does not consider that there is any credit risk associated with Government gilts. Non-linked assets not subject to credit risk include shares and other variable yield securities that are subject to market risk.

Group 2020

	AAA £000	AA £000	A £000	BBB and below £000	Not rated £000	Not subject to credit risk £000	Value in the balance sheet £000
Non-linked assets subject to credit risk:							
Financial investments – debt and fixed income securities	42,042	732,571	17,808	489,648	2,090	-	1,284,159
Cash and cash equivalents	-	-	108,852	-	-	-	108,852
Reinsurers' share of technical provisions	-	1,232,703	-	-	318,624	-	1,551,327
Other assets	-	9,398	-	-	51,747	(31,440)	29,705
Linked assets not subject to credit risk	-	-	-	-	-	1,889,919	1,889,919
Non-linked assets not subject to credit risk	-	-	-	-	-	235,380	235,380
Total	42,042	1,974,672	126,660	489,648	372,461	2,093,859	5,099,342

Group 2019

	AAA £000	AA £000	A £000	BBB and below £000	Not rated £000	Not subject to credit risk £000	Value in the balance sheet £000
Non-linked assets subject to credit risk:							
Financial investments – debt and fixed income securities	21,744	682,101	19,752	434,633	3,430	-	1,161,660
Cash and cash equivalents	-	-	110,427	-	-	-	110,427
Reinsurers' share of technical provisions	-	1,200,996	-	-	322,557	-	1,523,553
Other assets	-	7,975	-	-	12,284	(47,829)	(27,570)
Linked assets not subject to credit risk	-	-	-	-	2,057,703	-	2,057,703
Non-linked assets not subject to credit risk	-	-	-	-	291,096	-	291,096
Total	21,744	1,891,072	130,179	434,633	2,687,070	(47,829)	5,116,869

The derivative investments portfolio require third parties to pledge collateral for the derivative assets. The collateral is in the form of cash and, to help protect against credit risk, all collateral is to be held by an intermediary company.

No financial assets are past due or impaired at the reporting date and management expects no significant losses from non-performance by counterparties.

Other assets include premium debtors all of which are less than three months old. Scottish Friendly has never experienced a significant loss arising from premium debtors because it maintains the right to cancel a policy if premiums are not paid when due. No provision is made for impairment of these assets (2019: £nil).

Liquidity risk

Liquidity risk is the risk that a firm, whether solvent or not, either does not have available sufficient financial resources to meet its obligations as they fall due, or can secure them only at excessive cost. The key aspect is the risk of mis-management of short term cash flow that typically arises from the timing of premium receipts, maturities, claims and investment activity. Scottish Friendly managed this risk by monitoring cash flow across key transactions in the business, and investment strategies including level of liquid and readily marketable assets to allow for timely adjustments to match expected liabilities, if required.

The analysis below summarises the exposures the Group and Scottish Friendly carry in respect of liquidity risks. The earliest contractual repayment date of investment contracts with discretionary participation features and unit linked investment contracts is repayment on demand and therefore the undiscounted cash flows subject to liquidity risk are £205,680,000 (2019: £195,320,000) and £1,939,694,000 (2019: £2,539,146,000) respectively.

Other financial liabilities are repayable between 0-5 years as follows:

	Group		Scottish Friendly	
	2020 £000	2019 £000	2020 £000	2019 £000
Other financial liabilities	103,019	100,481	102,324	98,994

The tables below show the undiscounted expected maturity analysis of the Group's and Scottish Friendly's insurance contracts and investment contracts with discretionary participation features. These are the amounts that are guaranteed on maturity (or any earlier date where the surrender value is guaranteed).

Group

	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	Over 20 years £000	Total £000
2020						
Liabilities subject to liquidity risk:						
on-profit (insurance)	85,927	161,241	218,714	231,444	289,266	986,592
With-Profits (insurance)	421,313	326,978	160,766	96,076	108,266	1,113,399
Unit Linked	293,218	-	-	-	-	293,218
Investment	2,720,822	-	-	-	-	2,720,822
Other Liabilities	103,019	-	-	-	-	103,019
Total	3,624,299	488,219	379,480	327,520	397,532	5,217,050
2019						
Liabilities subject to liquidity risk:						
Non-profit (insurance)	88,981	151,737	196,639	211,773	286,325	935,455
With-Profits (insurance)	430,476	412,076	171,890	107,046	133,212	1,254,700
Unit Linked	313,919	-	-	-	-	313,919
Investment	2,813,488	-	-	-	-	2,813,488
Other Liabilities	100,481	-	-	-	-	100,481
Total	3,747,345	563,813	368,529	318,820	419,537	5,418,043

Amounts under unit linked contracts are generally repayable on demand and the Group is responsible for ensuring there is sufficient liquidity within the asset portfolio to enable liabilities to unit linked policy holders to be met as they fall due.

Fair value estimation

Disclosure of the fair value measurements for financial instruments held at fair value in the balance sheet by level of the fair value measurement hierarchy is detailed at Note 9.

The Group does not have any financial liabilities that are held for trading.

The fair value of financial instruments traded in active markets is based on quoted bid prices at the Balance Sheet date, as described in Note 9 to the Financial Statements. These instruments are included in Level 1 and comprise primarily listed equities, OEICs and debt instruments.

The Group closely monitors the valuation of assets in markets that have become less liquid. Determining whether a market is active requires the exercise of judgement and is determined based upon the facts and circumstances of the market for the instrument being measured. Where it is determined that there is no active market, fair value is established using a valuation technique. The techniques applied incorporate relevant information available and reflect appropriate adjustments for credit and liquidity risks. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity specific estimates. The relative weightings given to different sources of information and the determination of non-observable inputs to valuation models can require the exercise of significant judgement.

If all significant inputs required to fair value an instrument are observable, the instrument is included in Level 2. If one or more significant inputs are not based on observable market data, the instrument is included in Level 3.

Specific valuation techniques used to value financial instruments include:

- the use of observable prices for recent arm's length transactions;
- quoted market prices or dealer quotes for similar instruments; in particular, for corporate bonds for which there is no active market the fair value is based on broker/dealer price quotations. Where possible the Group seeks at least two quotations for each bond and considers whether these are representative of fair value in light of current traded levels. Where this information is not available or where it is considered to be not representative of fair value, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics; and
- other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments.

Note that all of the resulting fair value estimates are included in Level 2, except for certain asset back securities which are included in Level 3.

Market risk sensitivity analysis

The following table illustrates the impacts on the Scottish Friendly Main Fund of applying stress scenarios in line with the Standard Formula under Solvency II which are believed to be good approximations of the sensitivities under UK GAAP.

- The equity price sensitivity considers the changes in prices of UK and other type 1 equities as defined under Solvency II. This is a change in equity prices of ± 39% plus the symmetric adjustment of the equity capital charge as published by EIOPA.
- The property value sensitivity considers a 25% reduction in property values.
- The interest rate sensitivities are based on the Solvency II Standard Formula interest rate stresses, which are expressed as a duration dependent multiplicative factor applied to the base curve.

	2020 Impact £m	2019 Impact £m
Equity Fall	(21.4)	(12.7)
Property Fall	(1.6)	(0.8)
Interest Rate Fall	0.1	(1.2)
Interest Rate Rise	(0.6)	3.5

Consistent with the insurance risk sensitivity analysis within this note, for the purposes of the scenarios shown above, it has been assumed that the negative goodwill recognised in respect of the transfer from Canada Life Limited would be written down to absorb the impact of the scenario, with no impact on the FFA.

Financial Instruments

The company has the following financial instruments:

	2020 £m	2019 £m
Financial assets/liabilities measured as fair value through profit or loss		
Derivative financial instruments	27	25

Derivative financial instruments

The company holds interest rate swaptions to mitigate the interest rate risk associated with its non-linked business. At 31 December 2020, the outstanding contracts all mature within 7 years of the year end.

The interest rate swaptions are measured at fair value, which is determined using valuation techniques that utilise observable inputs. The key assumptions used in valuing the derivatives are interest rate curve data and interest rate volatility data.

22. NEGATIVE GOODWILL

	2020 £000	2019 £000
Carrying amount at the beginning of the period	(59,597)	(1,459)
Changes arising from new business combinations	-	(59,140)
Amortisation	6,062	1,002
Carrying amount at the end of the period	(53,535)	(59,597)

Negative goodwill occurs when the price paid for an acquisition is less than the fair value of the net assets acquired, where the transaction is considered to be a “business combination”.

Where books of insurance business are transacted this relates to the benefits that the seller achieves through a combination of streamlining their business activity so that it is aligned to their overall strategy, benefits that are achieved from a regulatory capital perspective, and different expense assumptions.

As noted above, this amount will be amortised over time as the capital requirements run-off and expected profits from this book emerge. This is estimated by the Directors to be over a 10 year period from inception.

Find out more about Scottish Friendly
at **www.scottishfriendly.co.uk**

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