Annual Report & Accounts

2019

Scottish Friendly

A warm welcome

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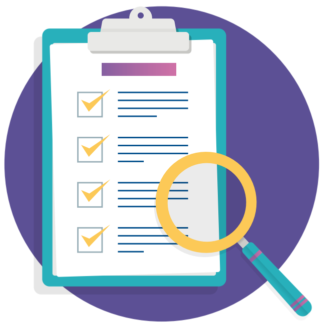

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For more information on Scottish Friendly and its products visit scottishfriendly.co.uk

Overview

2019 Highlights

"Scottish Friendly delivered another year of solid performance, with strong sales and the completion of a landmark acquisition resulting in a significant increase in assets under management."

Scottish Friendly delivered another year of solid performance, with strong sales and the completion of a landmark acquisition resulting in a significant increase in assets under management.

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

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

We're proud to be one of the largest mutual life offices in the UK, and one that's been around for over 150 years.

Sales (APE) [1]

37.8m

Sales of life protection through partnerships was a key driver of the £37.8 million (2018 - £38.6 million) sales figure total. Once again there was strong growth across Scottish Friendly's range of branded products,with a 12% increase in own brand sales.

Number of members

712,000

2019 has seen a substantial increase in the number of members, from 594,000 to 712,000 largely due to Scottish Friendly's acquisition of a £2.4bn book of life and pensions policies from Canada Life UK, that resulted in 90,000 additional members.

Assets under Management (AuM)[2]

£5.3bn

Assets under management rose from £2.8 billion to £5.3 billion, primarily due to the acquisition of a £2.4bn book of life and pensions policies from Canada Life UK.

Pillar 1 Capital

169%

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. As expected the capital has reduced in the year due to the dilution of capital following the acquisition of the Canada Life portfolio. Since the year end there has been significant global economic disruption as a result of the COVID-19 outbreak. This has impacted on asset prices, with significant falls in equities in particular, which has a knock-on impact on the capital ratio of Scottish Friendly. Actions have been taken to address this and the Group remains well capitalised, as detailed in the Directors' Report.

Investment Performance

12.0%

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 with-profits fund was 12%. This compares to the FTSE All Share Total Return Index performance of 19.2% and the FTSE Actuaries UK Conventional Gilts All Stocks Total Return Index of 6.9% over the year. Since the year end, there have been significant movements in financial markets, with global equity values falling significantly, and the markets remain highly volatile.

[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.

Chairman's Statement

Our continued commitment to our proven strategy for growth has resulted in another year of strong sales

Strategy

We are publishing these accounts against a background of serious uncertainty and widespread disruption caused by the outbreak of COVID-19. Our current priority is the health and wellbeing of our colleagues and delivering the key essential services, such as the payment of claims to our policyholders. In this environment, we have adjusted our client service capability and will continue to do so as events unfold in the period ahead. Our robust capital position and our business model means that although the COVID-19 outbreak, and the associated significant global economic disruption, has impacted the capital ratio of the business since the year end, Scottish Friendly remains well capitalised.

Notwithstanding all of this, I am pleased to announce another impressive set of results, despite another year of economic and political uncertainty. These results further prove that our long-term strategy, flexibility and resilience enables us to navigate and overcome the challenges we face whilst continuing to build our business for the future.

2019 was a landmark year for Scottish Friendly, with the completion of a significant acquisition of a book of life and pensions policies from financial services provider Canada Life. This helped to consolidate Scottish Friendly as one of the leading UK mutual organisations and a prominent player in the financial services industry. Our continued commitment to our proven strategy for growth has resulted in another year of strong sales of £37.8 million (2018: £38.6 million), the third highest in our 158-year history. This progress can be attributed to the three key areas of our Diversify and Grow strategy, namely:

- Organic growth through the development of our product range and distribution channels;
- Business process outsourcing for partners whilst leveraging our efficiencies; and

- Seeking mergers and consolidation within the life sector.

Assets under management roughly doubled, increasing by £2.4 billion to over £5 billion, with the number of members increasing by an estimated 90,000.

Once again, Scottish Friendly's e-business and direct marketing initiatives have continued to contribute significantly to our sales growth in 2019, delivering a 12% increase in income compared to the previous year. Our continued commitment to listen to our members through structured focus group sessions ensures we are at the forefront of changing customer behaviours, by providing us with key information to ensure our products and services are developed to meet their needs. We also received the affirming news that we were selected as the 'Best Junior ISA Provider' at the Investment Life & Pensions Moneyfacts awards in September.

We continue to test and learn 'best practice' with our various corporate partners, enabling Scottish Friendly to develop innovative products, including the development of a new life and critical illness product tailored for mortgage holders through our partnership with Guardian Financial Services. Our partners continued to contribute significantly towards our sales total for 2019.

Our on-going investment in innovative products, technology and customer service gives us the confidence that we will continue to add value to existing relationships and attract new business partners.

Going forward, the COVID-19 outbreak and the terms of the UK's exit from the EU will continue to dominate headlines, with economic and political debates continuing for the foreseeable future. However, Scottish Friendly will continue to react quickly to events and has the ability, know-how and confidence to do so going forward.

Our objective is clear: to provide products and services that cater for everyone, regardless of age, income or any previous financial experience. We are well placed to deliver these objectives and to further consolidate our position as a leading UK financial mutual.

The regulatory environment

This year has seen several areas of regulatory change and Scottish Friendly has implemented the relevant changes to ensure that we continue to meet the various requirements of our regulators.

New climate change requirements for insurers came into force from the PRA, reflecting the concerns of the Bank of England that the financial sector must `raise the bar` in climate risk measurement. Through the Own Risk and Solvency Assessment (ORSA), the Board is aware of the potential impacts of climate change on our business, and Scottish Friendly has nominated the Chief Risk Officer to be responsible for identifying and managing financial risks from climate change going forward.

Throughout 2019, a key priority for the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA) and Bank of England has been putting in place a stronger regulatory framework to promote operational resilience of firms

> "Our strategy for growth continues to deliver long term value to our customers in an uncertain economic environment."
>
> **Michael Walker**
> Chairman

and financial market infrastructures. By addressing resilience gaps, and building resilience, they believe firms will become more capable of supplying their most important business services even during severe operational disruption. Scottish Friendly has been closely monitoring the regulators' expectations and taking action in response in relation to operational resilience and how they expect firms to be able to prevent, adapt, respond to, recover and learn from operational disruptions. This work will continue throughout 2020, and beyond.

Following its Retirement Outcomes Review, the FCA implemented changes to its rules to help improve consumer engagement with retirement income decisions. Scottish Friendly introduced the required changes to customer disclosures; these aim to make these communications more effective and of greater impact.

Finally, throughout 2019 Scottish Friendly prepared for the UK's withdrawal from the EU on 31 January 2020. Our overarching commitment in this planning has been to ensure we continue to fulfil our obligations to customers and meet their expectations in relation to the services and products we provide.

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 37 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. From 1 January 2019, the AFM Corporate Governance Code took effect, replacing the Annotated Corporate Governance Code which had been in place since 2007. Scottish Friendly applies the principles set out in the Code and reports on them in our financial report and accounts.

We have maintained our ISO 27001 and ISO 22301 certifications, the International Standards for Information Security Management and Business Continuity Management respectively. These are further examples of our commitment to best practice and to the continued improvement and evolution of our key processes.

Corporate social responsibility

The Scottish Friendly Children's Book Tour supports Scottish Book Trust in its efforts to improve child literacy by organising visits by authors to primary and secondary schools across the UK.

In 2019 the programme continued to go from strength to strength, visiting deprived communities and remote areas across the UK to foster a love of reading, writing and illustration among young children.

The tour has reached 120,000 children since it began in 1998, with over 120 of the UK's leading authors and illustrators taking part.

Corporate recognition

Scottish Friendly continued to increase its media profile in 2019 across national, broadcast, online and regional press by adopting a number of methods, including the development of consumer research, regular commentary on industry topics affecting UK consumers and an increased focus on raising the awareness of the growth strategy of the organisation in the business pages of the national press. Increasing our voice throughout the media landscape highlights our credibility as a leading UK financial mutual and supports our marketing and sales objectives across the business.

April 2019 marked the 20th anniversary of ISAs, with our research analysing the returns associated with Cash and Investment ISAs since their inception. The research findings, generated from a survey of over 4,000 UK adults, also explored the attitudes and behaviours with regards to saving, examining the trends in popularity of the products over their twenty year history.

Scottish Friendly's people

I would once again like to take the opportunity to thank my colleagues from across the business for their continued hard work, drive and commitment to Scottish Friendly. Without them we would not be in a position to meet the strategic objectives set by the Board. We will continue to support them through these trying times to ensure we can continue to support our members.

2019 has seen the largest acquisition in our history and with that, our largest recruitment drive, to allow us to continue to offer excellent customer service to our existing and new members.

Scottish Friendly is in the fortunate position of being able to attract and retain highly skilled individuals who react to change swiftly and effectively to ensure that we continue to drive the business towards achieving its strategic goals while delivering the very best value for members, even in the present unprecedented environment.

M Walker
Chairman
21 April 2020

“2019 has been witness to the largest acquisition in our history and with that, our largest recruitment drive in order to continue to offer excellent customer service to our existing and new customer members.”

Chief Executive's Review

Strategy

Scottish Friendly understands the significance of continually looking at ways to improve the products we develop and the service we offer to customers in order to differentiate ourselves from others in the financial services market. Through innovation, efficient customer services and responsible capital management, Scottish Friendly is well placed to continue to achieve our vision to provide long-term sustainable growth in value for existing and future customers.

Scottish Friendly's strategy

Organic growth

Scottish Friendly's e-business and direct marketing activity continued to deliver successful sales growth. Despite economic uncertainty at the start of the year, we were well placed to benefit from the upturn at the year end as customer sentiment improved. This resulted in own brand business ending the year well, delivering a 12% increase in revenue versus the previous year.

During ISA season our 'ISAs are 20' campaign, celebrating the anniversary of ISAs being launched into the UK market in 1999, was key to driving up sales. The campaign included a prize draw that proved extremely popular across our spectrum of offline and online channels, including social media. This helped to achieve a significant uplift in sales in the run up to ISA season.

The ongoing development of our mobile app was a key highlight of 2019. New functionality included customers being able to add a new policy to their ISA as well as top up, increase and decrease payments and make withdrawals, all at the touch of a button. Enabling customers to manage their investments on the move has been popular with policyholders.

Being crowned winner of the 'Best Mutual Insurer' award by the CFI in July was a great achievement for everyone, only to be followed with incredible news that we had won the 'Best Junior ISA Provider' award at the Investment Life & Pensions Moneyfacts awards in September. The nominations for both categories were based on the public's vote, with the ultimate winner decided by a panel of credible industry experts and we are all incredibly proud of winning both awards. Junior ISA sales benefitted from the accolade with an increase in transactions year on year since winning our award. This prompted a Junior ISA first strategy on paid search channels and an increase in traffic coming to the website from 'best junior ISA' search terms. This will serve us well in 2020 as we continue to position Scottish Friendly as the best provider to help people invest for their future.

"As one of the leading UK mutual insurers, Scottish Friendly is proud to be owned by, and run, for the benefit of our members."

Jim Galbraith
Chief Executive

Partnerships business process outsourcing

Scottish Friendly's significant range of corporate partnerships continued to be a key contributor to the Group's strong results in 2019. In addition, the Guardian product portfolio, available through financial advisers, has gone from strength to strength during the first full year of trading in 2019. Scottish Friendly supported Guardian with a new life and critical illness product suitable for clients looking to protect their mortgage. The product launched towards the end of the year, providing a strong platform for growth into 2020 and beyond. We are confident our on-going investment in innovative products, technology and customer service, will continue to add value to existing relationships and attract new business partners.

Mergers and consolidation

Scottish Friendly has a long and well-established history of acquiring large books of insurance business. In November 2019 Scottish Friendly completed the acquisition of a significant book of UK life and pensions business from Canada Life, increasing assets under management to over £5 billion. As part of the transaction the future administration of around 120,000 endowments, whole of life policies, investment bonds, pensions and protection policies, mostly written before 2003 transferred to Scottish Friendly. This was a transformational deal for Scottish Friendly and the largest in its 158-year history. Since 2005, Scottish Friendly has acquired nine books of business and continues to look for new opportunities.

We were able to acquire this block of business for less than the book value of assets to support our capital requirements going forward. Therefore, from an accounting perspective, we have created a negative goodwill asset on the balance sheet. This will be released over time as the capital requirements run-off and expected profits for this book emerge.

> "Our mutual status continues to support our strategy for growth, helping to deliver another year of positive results."

Results

Scottish Friendly delivered another strong set of results in 2019 against challenging market conditions. Total sales were £37.8 million APE (the industry standard measure of annual premium equivalent – regular premiums plus one tenth of single premiums). These are the third best sales results in our history.

The corresponding figure in 2018 was £38.6 million. Of the 2019 total, protection sales were £19.5 million (2018: £24.3 million) and savings and investments, which includes Scottish Friendly own brand, whole of life and savings partners, amounted to £18.3 million (2018: £14.3 million). Included within savings and investments, Scottish Friendly own brand sales increased in 2019 to £13.5 million (2018: £12.1 million).

Earned premiums increased to £125.5 million (2018: £110.5 million). Net premium income (after reinsurance) from insurance contracts increased to £73.8 million (2018: £65.7 million) and premiums earned on investment contracts increased to £43.6 million (2018: £32.5 million). The ratio of administration expenses to total premium income APE increased to 8.5% (2018: 6.9%). The Net Transfer to the Fund for Future Appropriations for the year was £6.2 million (2018: £14.4 million).

Scottish Friendly membership increased from 594,000 in 2018 to 712,000 in 2019, taking into account the significant number of new customers transferring from Canada Life. Scottish Friendly administers more than one million policies across more than 350 product lines.

Financial position

The return on the asset shares within the Scottish Friendly with-profits fund for 2019 was 12.0%, against -3.7% in 2018. This performance reflects a year of positive returns across all asset classes against a backdrop of continued market volatility, which saw the FTSE All Share Index increase by 19.2% and the FTSE Actuaries Government Securities All Stocks Total Return index increase by 6.9%. The performance of the fund supports the current and future ability to pay bonuses to our with-profits policyholders. Scottish Friendly assets under management grew significantly to over £5.3billion, compared to £2.8billion in 2018, primarily due to the acquisition of a significant book of business from Canada Life UK.

Our capital position as measured by the solvency coverage ratio remains strong at the year end date and, at 169% (2018: 188%), was significantly in excess of the regulatory requirements under the Solvency II regulatory regime that applies

> "These results demonstrate our continued resilience through challenging times, allowing us to seek new opportunities to grow the business."

to insurers. As expected, the ratio had reduced to reflect the acquisition of the business from Canada Life, with some limited impact from declining interest rates over 2019.

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 year end, Scottish Friendly remains well capitalised. The solvency position is being monitored frequently, with appropriate actions taken to protect the long-term interest of policyholders and the overall capital position of Scottish Friendly.

Scottish Friendly continues to have a capital position in excess of the levels required by the regulations, and remain above the minimum tolerance levels set for Scottish Friendly by the Board, which themselves are designed to provide a strong level of protection for policyholders.

To support the continuation of this position, certain actions have been taken to improve the solvency position and to reduce exposure to further market falls. These have focussed on the areas of the business with the greatest exposure to market risks, particularly the business held in the M&GM sub-fund, and have included de-risking of certain assets and additional matching activity.

The Group reinsures a significant proportion of its insurance risks to a number of reinsurers, and maintains an appropriate level of matching of assets and related liabilities. At this time, Scottish Friendly has not seen any impact on the credit standing of its reinsurers or of the Group's access to such markets.

Scottish Friendly's Fund for Future Appropriations is £190.9 million at the year end with a surplus of £6.2 million being generated in the year. The Fund for Future Appropriations represents funds that have not been allocated to specific policyholders and free assets.

Investment Strategy/ESG

Scottish Friendly aims to invest its funds in a responsible manner in line with the requirements of our policyholders. Scottish Friendly has an approved Environmental, Social and Governance (ESG) Policy which it monitors through the Investment Committee.

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

May 2019 saw the establishment of the With-Profits Committee as part of our continued commitment to create the best possible governance structure. Details of its membership and terms of reference are set out on page 37.

Outlook

COVID-19 dominates the current outlook for the UK. We will continue to adapt and adjust our operational framework to enable us to look after the wellbeing of our staff and continue to deliver essential services to our members. Despite the current economic uncertainty Scottish Friendly remains well capitalised. Results in 2019 have yet again demonstrated our ability, flexibility, drive and determination to be resilient through these challenging times whilst continually looking for opportunities to further grow the business.

Scottish Friendly takes 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. We recognise the challenging times that we live in and our key focus remains on the health and safety of our staff and continuing to service our members to the best of our ability.

We remain confident for the future.

J Galbraith
Chief Executive
21 April 2020

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

Michael J Walker LLB
Chairman

Appointed as a Director and as Chairman in January 2009. Chairman of the Nomination Committee and a member of the Remuneration 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 and M&GM Assurance (Trustees) Limited. Recently retired as Chairman of Walkers Shortbread Limited and former Chairman of legal firm Maclay Murray & Spens.

Dermot J Jenkinson
Vice-Chairman and Senior Independent Director

Appointed as a Director in November 2011. Member of the Audit Committee and of the Nomination Committee. Appointed Vice Chairman 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.

David C Huntley BA, FIA
Appointed as a Director in January 2013. Chairman of the Remuneration Committee and the Risk Committee. Member of the Audit Committee. Director of the Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited and SF Pension Managers & Trustees Limited. With over 30 years of experience across the life and pensions industry as well as in consulting and executive business coaching, has held senior positions in a number of businesses including Managing Director of Pearl Life Division and CEO of Swiss Re Life and Health Australia. Currently Chair of FIL Life Insurance Limited and FIL Life Insurance (Ireland) DAC and Non-Executive Director of Loughborough Building Society.

Directors (cont)

Kerr Luscombe BSc, FFA

Appointed as a Director in June 2015. Chairman 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.

Anja M Balfour BSc (Hons), ASIP

Appointed as a Director in April 2018. Chairman of the Investment Committee and member of the Risk Committee and With-Profits Committee. Currently Chair and Non-Executive of Schroder Japan Growth Fund plc. Also holds Non-Executive Director positions at AVI Global Trust plc and BMO Global Smaller Companies 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 DC Alpha Investments SPC Ltd. Also holds Non-Executive Director positions in Meallmore Ltd, Martin Currie Global Portfolio Trust and Royal Edinburgh Military Tattoo and is a Trustee of the Boswell Trust.

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 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.

Executive

J Galbraith BSc, MBA, FFA
Chief Executive

NE Lovatt ACII, BA, MSc (Dip)
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 (Joined 25 March 2019)

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 2019. 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, JISAs 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

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 18.

Further information on the Board is set out in the Report on Corporate Governance on pages 24 to 37.

Statement of solvency

In the opinion of Scottish Friendly's Chief Actuary and the Board, Scottish Friendly had the required margin of solvency as prescribed in the Solvency II regulatory requirements as at 31 December 2019 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 Chief Actuary, 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 impact of COVID-19, on the business over the going concern period. COVID-19 has caused disruption to businesses and economic activity which has been reflected in fluctuations in global stock markets since the year end.

In the going concern period, the Board has assessed the fact that the Group will 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 assessing the impact of the pandemic on the credit standing of its key reinsurance counterparties.

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 range 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 threat from COVID-19 on the business. This enables management to take any necessary actions to manage risks and de-risk the balance sheet to ensure the adequate level of capital is held, in line with Scottish Friendly's risk appetite.

Overall, this empowers 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 have also considered the impact of COVID-19, on the business. COVID-19 has caused disruption to businesses and economic activity which has been reflected in recent fluctuations in global financial markets.

In this environment, the Board have recognised that the Group will need to adjust its client service and operational capabilities as events unfold in the period ahead, and are in response upscaling its ability 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, and the associated significant global economic disruption, has impacted the capital ratio of the business since the year end, Scottish Friendly remains well capitalised. The Group also reinsures a significant level of its insurance risks to a number of reinsurers, and at this time has not seen any impact on the credit standing of these reinsurers or of the Group's access to such markets.

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 that 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: www.scottishfriendly.co.uk/tax-strategy

Employees

Scottish Friendly is committed to a policy which ensures that, in all aspects of recruitment, training and career development, equal opportunities are afforded to job applicants and employees irrespective of their age, race, religion, sex, marital status, sexual orientation or disability. If employees become disabled during the period of employment, Scottish Friendly will endeavour to retrain or redeploy individuals to enable their employment to continue.

Scottish Friendly has an established system of communication utilising a clearly defined line management structure both to convey information concerning Scottish Friendly's performance to staff and to receive from staff input relative to Scottish Friendly and their part in its operation. Regular meetings are held by managerial staff for this purpose, reinforced by intranet updates and other written communications and business wide briefings. In addition, a Staff Committee acts as a further mechanism through which matters, both formal and informal, can be communicated between staff and the 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 2019, Scottish Friendly had 1,388,000 (2018: 1,256,000) policies and estimated the number of members to be 712,000 (2018: 594,000).

Post balance sheet events

The directors consider the emergence of Covid-19 as a pandemic during 2020, and the associated government measures both in the UK and overseas in response, as a non-adjusting post balance sheet event. Further detail can be found in note 24 to the financial statements.

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 judgments 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
21 April 2020

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 points 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 AFM in response to the Code, with explanations included where appropriate within this report.

Scottish Friendly is subject to the Senior Managers & Certification Regime (SM&CR) introduced 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 eight occasions in 2019 and informally on two occasions (May and November strategy sessions). 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 except for apologies from the Chairman on two occasions and the following apologies from Non-Executive Directors and Directors:

- Apologies on two separate occasions for Board meetings from two Non-Executive Directors;
- Apologies on two separate occasions from two Non-Executive Directors for the Audit Committee;
- Apologies on two separate occasions from three Non-Executive Directors for the Risk Committee;

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 May to set out the strategic framework and 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	
Michael J Walker	8 (8)	–	7 (8)	3 (3)	3 (4)	5 (5)	–
Dermot J Jenkinson	8 (8)	5 (5)	–	–	–	5 (5)	–
David C Huntley	8 (8)	5 (5)	8 (8)	3 (3)	–	–	–
Kerr Luscombe	8 (8)	5 (5)	8 (8)	3 (3)	–	–	4 (4)
Anja Balfour	7 (8)	–	6 (8)	–	4 (4)	–	4 (4)
Gillian Watson	7 (8)	4 (5)	–	3 (3)	–	–	–
Jim Galbraith	8 (8)	–	8 (8)	–	4 (4)	5 (5)	–
Neil Lovatt	8 (8)	–	–	–	–	–	–
Martin Pringle	8 (8)	–	–	–	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 Chairman 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. Over 2019, reflecting the growth in the business arising from the Canada Life transfer, Scottish Friendly made a significant investment in ensuring that the risk framework and function remain appropriate given the increased nature and scale of 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:

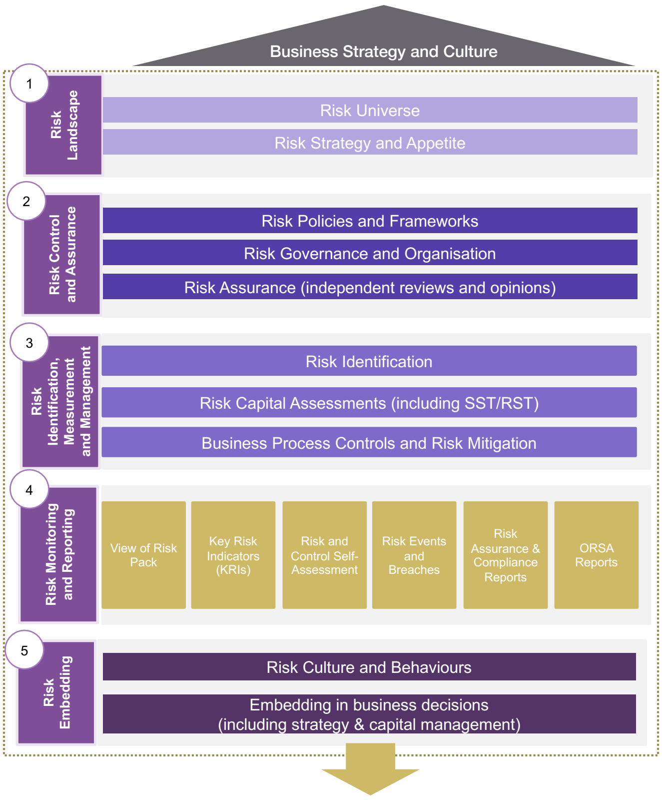
Risk Management Framework

Risk Landscape

The Risk Universe categorises all the risks to which the business is exposed which provides a common language for risk across the business and a structure for assessing and reporting risk. There are 3 risk categories – Level 1 is the highest level which is further 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 consider the implications of the current strategy and the risks that are created in pursuit of the objectives. The assessment considers not only the strategic

Risk Management Framework



priorities at the point in time of the assessment, but also what is proposed over the planning horizon and potential deviations from the agreed strategy.

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 ensuring compliance with the standards across the company on an ongoing basis. The Risk Function provide oversight and challenge of this process. In order to facilitate effective implementation of Scottish Friendly's risk policies across the business, a Risk Policy Framework has been established.

Scottish Friendly adopts the 'Three Lines of Defence' model to define the roles and responsibilities for risk management throughout the organisation.

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

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

The Second Line of Defence is represented by the Executive Risk Committee and Board Risk Committee and control functions that provide ongoing oversight and challenge of the risk exposures and internal control environment. The Risk and Compliance functions provide independent challenge and oversight of each business function, led by a designated Chief Risk Officer and a Head of Compliance. The Risk Function has a clear mandate which is set by the Board. The purpose of Scottish Friendly's Risk and Compliance Functions are to:

- Oversee and ensure the identification and management of risk by the business for the benefit of the society 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;
- 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.

Internal Audit provides the Third Line of Defence by delivering a cyclical and prioritised programme of risk based audits covering all aspects of work undertaken in the First and Second Line business areas over a period of years.

The overall accountability for risk within the business ultimately rests with the Board. Some responsibilities have been delegated 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 business risk. On behalf of the Board, the BRC also conducts an annual assessment of the effectiveness of the Risk

Report on Corporate Governance (cont)

function. Further information is set out below on the activities of the Audit and Risk Committees during 2019.

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 and are required to report on their respective area at the ERC on at least a quarterly basis.

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

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

Risk Identification, Measurement and Management

Both current and emerging risks are identified in a number of ways, and start with an understanding of what internal and external uncertainties exist and what impact they have on strategic objectives. Risks are identified using a variety of techniques, including business risk self-assessments, risk workshops, horizon scanning and forward looking 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 period 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 statements 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 emerging 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 form the basis for regular risk reporting:

- View of Risk Summary Pack 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 prioritized management awareness and response.
- Key risk indicators (KRIs) - For each risk category KRIs and associated metrics have been developed and agreed. These 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. The reporting analyses the root cause, 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 are 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 department's resulting assessment of residual risk and to advise on best practice in the development of controls.
- The Own Risk and Solvency Assessment (ORSA) is an integral part of the strategic decision making process within Scottish Friendly and its results inform capital management, investment and product development decisions taken by the Executive and the Board. As well as this, the ORSA creates a link between the risks that are being taken to deliver the strategy and the capital implications that arise as a consequence of the chosen strategy. 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 Own Risk and Solvency Assessment (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 and 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 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 embeds risk management in the day-to-day business processes through operation of effective controls.
- Embedding risk management in the management of change within our business.

Report on Corporate Governance (cont)

- Embedding of risk supports enhancement of business performance and capital management to the benefit of our policyholders and delivery of Scottish Friendly's strategy.

Principal risks

Scottish Friendly operates an ongoing process to identify, monitor, manage and mitigate risk. 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 either quantifiable risks or non-quantifiable risks.

Quantifiable risks

These are the risks within the Risk Universe which can be meaningfully quantified. These are:

- Insurance risk 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, pricing and expense experience.
- Market risk is defined as the risk that market movements focused on fluctuations or adverse impacts to the value of assets and liabilities result in financial loss or non-financial impact.
- Credit risk 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.
- Operational risk 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 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

Non-quantifiable risks

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 a combination of strategic and operational steps. Scottish Friendly has strategic diversification from the manufacturing 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.

- The primary SBER risk is the emergence of the recent COVID-19 pandemic. The operational and financial business resilience plans have been implemented and action has been taken to minimise the potential impact on the business, our staff and customers. The capital and liquidity position remain resilient following recent market volatility, with further detail on pages 7 to 15. Notwithstanding, in keeping with the Risk Management Framework, the evolving pandemic is being closely monitored and action will continue to be taken to minimise its impact on the Group,
- 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

Scottish Friendly also operates an emerging risk process, based on analysing external industry research publications and obtaining input from experts within the business, to identify new or changing risks that can have a serious impact on the business environment and broader society. These risks are known to some degree, but are not likely to materialise or have an impact for several years. However, 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. This has included an assessment of the impact of a "Hard Brexit", and the failure of a significant reinsurance counterparty.

The current priority is the emerging risks from the COVID-19 pandemic. This includes the health and wellbeing of the Group's colleagues so that the Group can continue to deliver for customers and clients, the operational resilience of the business, and the capital and liquidity position of the Group and the credit rating of reinsurers.

Other key emerging risks are:

- **Climate change** - Scottish Friendly cares deeply about its impact on the environment and is already active in reducing its carbon emissions – all staff are based in a single location, which minimises business travel, and the business is increasingly moving to a "paper-free" operating environment. Scottish Friendly is also actively considering the financial impacts of climate change on the business – as part of the ORSA process a climate change scenario was modelled and the results of this was considered by the Board and Executive team as part of the annual strategic planning process. Scottish Friendly will continue to stay aligned with emerging industry practice in relation to climate change modelling and financial disclosures, and continues to monitor the impact of Climate change on the Investment strategies adopted
- **Scottish independence** - Potentially Scottish Independence could have an impact on Scottish Friendly's ability to sell products into the rest of the UK (outside Scotland) and impact Scottish Friendly's ability to service existing customers. The impact of this emerging risk arising from Scottish Independence is viewed as a low on the basis of Brexit experience and with a view that political will should exist to develop appropriate solutions to support continued cross-border trade. However, Scottish Friendly is exposed to secondary impacts from a 2nd independence referendum including business disruption potentially generating a recession for segments of the target market and the potential negative brand perceptions. This is closely monitored to ensure appropriate steps will be taken in a timely manner to minimise the impact of these risks.
- **Cyber security** - Effectively dealing with cyber risks remains a priority in ensuring Scottish Friendly is operationally resilient and able to successfully implement strategy. Cyber challenges continue to develop and become more sophisticated, with more material impacts. Scottish Friendly continues to remain vigilant and will continue to invest in appropriate cyber defences to ensure customers do not come to harm and the brand remains intact.
- **COVID-19** - The long-term impact of COVID-19 on claims and lapse experience, and its effect on economic outlook more generally, remains very uncertain. Scottish Friendly will closely monitor emerging experience and will

Report on Corporate Governance (cont)

take mitigating actions where required. The history of the Group, experienced staff and risk management procedures in place provide assurance that the business is well placed to adapt to any long-term disruption.

In prior years, Brexit has been identified as a key emerging risk. In response to this risk, Scottish Friendly has developed a contingency plan to ensure the continuity of service to impacted customers can be maintained. Overall Brexit is expected to have a limited impact on the business.

Directors

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

In addition to the Chairman and Vice-Chairman, the Board comprised, as at 31 December 2019, 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 Chairman 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 Chairman. 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 he 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 38 to 39.

Performance evaluation

On at least an annual basis, the Chairman 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 Chairman. The performance of the Chairman 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 2019 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 38 to 39.

Audit Committee

- **Kerr Luscombe (Chairman)**
- **Dermot Jenkinson**
- **David Huntley**
- **Gillian Watson**

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 Chairman, CEO, Finance Director and CRO all attend the Audit Committee meetings.

During 2019 the Committee met formally on five occasions, with apologies from Ms Watson and Mr Jenkinson on one occasion. 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 Audit Plan which highlighted key judgment 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 judgmental areas, the appropriate accounting treatment and additional disclosure required due to the acquisition of the Canada Life portfolio 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;
- considered the impact of COVID-19 on the going concern status of the business and reviewed the related disclosures presented in the Report and Accounts;
- 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 Chief Actuary covering methodology, assumptions, significant judgments and other factors impacting the provisions and recommends their approval to the board, this included the impact of the Canada Life transfer of business 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 (Chairman)**
- **Michael Walker**
- **Jim Galbraith**
- **Martin Pringle**
- **Alan Rankine**
- **Bryan Johnston**

During 2019 the Committee met on four occasions, with apologies from Mr Johnston and Michael Walker (the Board Chairman) on one occasion. 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 (Chairman)**
- **Jim Galbraith**
- **Dermot Jenkinson**

During 2019 the Committee met formally on five 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 judgment to the Board. The Committee also ensures that Scottish Friendly's employee policies, described on page 22, are applied in Board nomination matters.

Scottish Friendly has a Board diversity policy and the Nominations 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

- **David Huntley (Chairman)**
- **Kerr Luscombe**
- **Michael Walker**
- **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 2019 the Committee met on eight occasions, with apologies from Ms Balfour on two occasions and the Board Chairman on one occasion. 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 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;
- reviewed the relevant risks associated with the Canada Life transactions including the risk oversight of the proposed acquisition; and
- reviewed and ensured the fulfilment of the terms of reference of the Committee and examined Committee effectiveness.

With-Profits Committee (with effect from May 2019)

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

The With-Profits Committee was created in May 2019 to enhance the governance and oversight of the management of the with-profits business held by Scottish Friendly and the operation of its With-Profits funds. This includes aspects of the management of the Scottish Friendly Main Fund along with the operation of the following closed sub funds: Marine & General Mutual, Scottish Legal Life, LANMAS, Rational Shelley and the newly acquired ManuLife sub fund acquired from Canada Life.

During 2019 the Committee met on four occasions. 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 the firm 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 (30 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

- **David Huntley (Chairman)**
- **Michael Walker**
- **Kerr Luscombe**
- **Gillian Watson**

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

The Committee consists of three independent Non-Executive Directors, as well as Michael Walker, 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 Chairman are set by the Committee in his absence and for Non-Executive Directors are set by the Executive Directors and the Chairman. Changes are effective from 1 May. Fees are designed to recognise the responsibilities of Non-Executive Directors and to attract individuals with the necessary skills and experience to contribute to the future development of Scottish Friendly.

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

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

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 2019 £000	Year ended 31 Dec 2018 £000
Chairman						
Michael J Walker	90	–	–	3	93	88
Executive Directors						
Jim Galbraith	414	133	33	95	675	658
Neil Lovatt	181	54	–	16	251	229
Martin Pringle	180	91	–	8	279	243
Non-Executive Directors						
Anja Balfour	53	–	–	–	53	38
David C Huntley	58	–	–	2	60	56
Dermot J Jenkinson	49	–	–	2	51	47
Kerr Luscombe	53	–	–	–	53	52
Gillian Watson	44	–	–	1	45	29

[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.

Accounts

Investments represent Scottish Friendly's most significant asset balance, £3.5bn at 31 December 2019

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'), which includes the parent Scottish Friendly Assurance Society ('Scottish Friendly'):

- give a true and fair view of the state of the Group's and of Scottish Friendly's affairs as at 31 December 2019 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 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 24, excluding the capital disclosures in note 16 calculated in accordance with the Solvency II regime, and excluding the risk disclosures in note 24 which are marked as unaudited.

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 Scottish Friendly or the Group.

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: • Impact of COVID-19 post balance sheet event; • Actuarial assumptions related to cost of guarantee reserves and the setting of assumptions on future mortality and morbidity in the protection business; and • Valuation of less liquid and complex investments.
Materiality	The materiality that we used for the Group financial statements was £5,600,000 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 a materiality level determined with reference to the scale of the businesses concerned and, other than Scottish Friendly, were significantly lower than Group materiality, being set between approximately £1,400 and £5,320,000.

Significant changes in our approach	Given the rapid spread of Coronavirus ("COVID-19","the virus") and the ongoing uncertainty surrounding its impact after the balance sheet date, and due to the inherent management judgement in determining the appropriateness of related post balance sheet event disclosures, we have enhanced our risk assessment and focused a greater degree of audit effort over the appropriateness of such disclosures in the financial statements. In accordance with this greater level of audit effort, we have identified a new key audit matter in the period relating to the appropriateness of the COVID-19 post balance sheet event disclosures. The key audit matters relating to the setting of actuarial assumptions and the valuation of complex investments are new in the current year, but have been pinpointed from our prior year key audit matters to the areas of more significant judgement and estimation uncertainty following the acquisition of a book of business from Canada Life Limited.

Conclusions relating to going concern, principal risks and viability statement

Going concern

We have reviewed the directors' statement on page 21 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's and Scottish Friendly's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

We considered as part of our risk assessment the nature of the Group, its business model and related risks including where relevant the impact of the Covid-19 pandemic and Brexit, the requirements of the applicable financial reporting framework and the system of internal control. We evaluated the directors' assessment of the Group's ability to continue as a going concern, including challenging the underlying data and key assumptions used to make the assessment, and evaluated the directors' plans for future actions in relation to their going concern assessment.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Principal risks and viability statement

Based solely on reading the directors' statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the directors' assessment of the Group's and Scottish Friendly's ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to:

- the disclosures on page 21 that describe the principal risks, procedures to identify emerging risks, and an explanation of how these are being managed or mitigated;
- the directors' confirmation on page 21 that they have carried out a robust assessment of the principal and emerging risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity; or
- the directors' explanation on page 21 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

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.

Impact of COVID-19 post balance sheet event

Key audit matter description

Subsequent to the balance sheet date a global pandemic of a new strain of Coronavirus has emerged. The virus, and responses taken by organisations and governments to manage its spread in markets to which the Scottish Friendly and the Group are exposed, have led to increased volatility and economic disruption. The matter is a non-adjusting event since it is indicative of conditions that arose after the reporting period.

Management have measured the assets and liabilities to reflect only the conditions that existed at the reporting date. Subsequent to the year end, management have performed procedures to assess the financial and operational impacts of COVID-19, at Scottish Friendly and Group level, including:

- an assessment of operational resilience, challenging internal control and governance, critical business functions, crisis management, and the impact on key stakeholders;
- considerations of solvency and liquidity projections, including further assessment of the exposure across the Group to equity market risk, widening credit spreads and falls in yields; and
- a review of balance sheet asset and liability valuations. Through this review management considered the exposure of financial assets to equity, interest rate and credit risk, susceptibility of reinsurers to credit risk, and sensitivity of technical provisions to adverse mortality, and expense assumptions.

The assessment of the impact of COVID-19 on Scottish Friendly and the Group, requires management judgement and consideration of a range of factors. Management have placed a particular focus on the level of capital surplus that has been maintained post year end, the risks associated with liquidity, and the credit quality of assets.

Having considered the results of the activities described above, management believes that Scottish Friendly and the Group continue to be a going concern due to having a stable solvency position and appropriate plans to manage liquidity and credit risks. The Group's business continuity plans have also been initiated and management believe that these will enable them to continue to deliver critical business services across the Group.

Scottish Friendly and the Group have made disclosures throughout the annual report and financial statements to reflect the results of its assessment, in line with applicable accounting standards, and relevant corporate governance code provisions. Due to the inherent management judgement in, and the increased level of audit effort focused on the appropriateness of, the financial statement disclosures, we considered these to be a key audit matter.

Refer to management's disclosure in notes 2 and 24 of the financial statements. Further detail is also included on pages 21 and 22 of the directors' report.

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

We evaluated management's approach to assessing the impact of COVID-19 on Scottish Friendly and the Group, and challenged the financial statement disclosures by performing the following procedures:

- 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;
- considered the actions that came out of the various governance committee meetings which considered COVID-19 in advance of reporting;

- evaluated management's assessment of the risks across the Group, including: solvency risk, credit risk, liquidity risk, and operational matters;
- assessed the mitigating actions management have put in place, and further plans they have if required, due to further deterioration of the wider UK and Global economy; and
- assessed the post balance sheet event and going concern disclosures made by management in the financial statements, based on our knowledge gained throughout the audit.

Key observations

Based on the procedures performed above, and the evidence obtained, we consider that, in relation to the potential impact of COVID-19, the post balance sheet event and going concern disclosures in the financial statements are appropriate.

Actuarial assumptions related to cost of guarantee reserves and the setting of assumptions on future mortality and morbidity in the protection business

Key audit matter description

The Group's technical provisions are 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 are valued at £872m (2018: £729m) and non-profit insurance contracts at £804m (2018: £567m), 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 the 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.
- 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 high level of assumptions and judgements involved, we determined that there was a potential for fraud through possible manipulation of the key assumptions 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 economic inputs to the model. We also tested the movements in the CoG 'analysis of change' by considering market and policy value movements in 2019.

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.

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

We challenged the applicability of existing assumptions to the new Canada Life business, and the methodology applied in setting assumptions for this new book.

For the actuarial models applicable to CoG and the protection business, we reviewed the script code to determine whether any changes to the models were operating correctly.

Key observations

The reserves held for future costs of guarantees ('CoG'), was 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, £3.5bn at 31 December 2019 (£1.3bn at 31 December 2018), 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 or estimation uncertainty, being:

- Investments in property funds of £64m, which are primarily open-ended and therefore carry a higher liquidity risk, and
- Swaption contracts valued at £25m, which are complex derivative contracts that provide Scottish Friendly with an option to enter into an interest rate swap on the expiry date.

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.

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 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

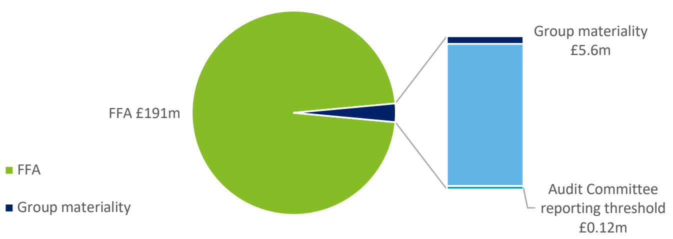
The property fund investments and swaption valuations were considered to be reasonable.

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	Society financial statements
Materiality	£5,600,000 (2018: £5,500,000)	£5,320,000 (2018: £5,445,000)
Basis for determining materiality	2.9% (2018: 3%) 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 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% (2018: 99.97%) of the total asset position being composed of Scottish Friendly held assets. As such, a component materiality threshold cap of 99% of Group materiality (2018: 99%) has been applied to reflect the significance of Scottish Friendly to the Group structure.



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 performance materiality was set at 70% of Group materiality for the 2019 audit (2018: 70%). 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 level of audit adjustments identified in the previous audit.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £112,000 (2018: £110,000), 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 a materiality level calculated with reference to the scale of the businesses concerned and were significantly lower than Group materiality being set between approximately £1,400 and £81,000 (2018: £1,400 and £72,000).

Scottish Friendly materiality was set at £5,320,000 (2018: £5,445,000) 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 audit engagement team.

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report and Note 16 to the financial statements, and excludes the other elements of the financial statements and our auditor's report thereon.

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.

In connection with our audit of the financial statements, 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 audit or otherwise appears to be materially misstated.

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

In this context, matters that we are specifically required to report to you as uncorrected material misstatements of the other information include where we conclude that:

- Fair, balanced and understandable – the statement given by the directors that they consider the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy, is materially inconsistent with our knowledge obtained in the audit; or
- Audit Committee reporting – the section describing the work of the Audit Committee does not appropriately address matters communicated by us to the audit committee.

We have nothing to report in respect of these matters.

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.

Details of the extent to which the audit was considered capable of detecting irregularities, including fraud and non-compliance with laws and regulations are set out below.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council'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

We identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and then design and perform audit procedures responsive to those risks, including obtaining audit evidence that is sufficient and appropriate to provide a basis for our opinion.

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, the internal audit function 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:
- identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
    - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud;
    - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations;
- the matters discussed among the audit engagement team and involving 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 Group 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 the recording of premiums for the protection business. Further, 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 pensions 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'). In particular, compliance with regulatory solvency requirements were fundamental to Scottish Friendly's ability to continue as a going concern.

Audit response to risks identified

As a result of performing the above, we identified two key audit matters relating 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 relevant laws and regulations discussed above;
- 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;

- in addressing the risk of fraud in revenue recognition, substantiating premiums recorded for the protection business by tracing to third party invoices/data, tracing cash flows through bank 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.

Report on other legal and regulatory requirements

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 has been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the Group and of 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

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 that we require for our audit.

We have nothing to report in respect of these matters.

Other matters

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 8 years, covering the years ending 31 December 2012 to 31 December 2019.

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
21 April 2020

Income and Expenditure

Technical Account – Long Term Business
For year ended 31 December

	Note	Group 2019 £000	Group 2018 £000	Scottish Friendly 2019 £000	Scottish Friendly 2018 £000
Earned Premiums		125,529	110,468	125,529	110,468
Reinsurance Premiums		(51,699)	(44,772)	(51,699)	(44,772)
Earned Premiums, Net of Reinsurance	3	73,830	65,696	73,830	65,696
Investment Income	4	60,323	87,403	60,323	87,403
Unrealised (Losses)/Gains on Investments		124,596	(136,479)	125,414	(135,642)
Other Technical Income		21,055	16,807	18,565	14,199
Amortisation of Negative Goodwill	23	1,002		1,002	
		280,806	33,427	279,135	31,656
Claims Incurred		175,730	154,161	175,730	154,161
Reinsurance Claims		(80,987)	(76,786)	(80,987)	(76,786)
Net Claims Incurred	5	94,743	77,375	94,743	77,375
Change in Other Technical Provisions		106,845	(93,489)	106,845	(93,489)
Operating Expenses	6	55,966	45,085	55,966	45,085
Investment Expenses & Charges		825	422	825	422
Other Technical Charges		2,555	2,364	1,079	777
Tax attributable to Long Term Business	8	11,150	(4,283)	10,954	(4,467)
Actuarial Loss/(Gain) re pension scheme		2,484	(8,481)	2,484	(8,481)
Transfer to/(from) the Fund for Future Appropriations		6,238	14,434	6,238	14,434
		280,806	33,427	279,134	31,656

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 52 to 83 form an integral part of these accounts

Balance Sheet

ASSETS
As at 31 December

	Note	Group 2019 £000	Group 2018 £000	Scottish Friendly 2019 £000	
Investments					
Land & Buildings		3,500	3,500	3,500	3,500
Other Financial Investments		1,197,425	719,227	1,197,146	719,151
Investments in Group Undertakings		–	–	3,448	3,114
Non linked Financial Investments		1,200,925	722,727	1,204,094	725,765
Assets Held to Cover Linked Insurance & Investment Liabilities		2,309,535	549,511	2,309,535	549,511
Total Financial Investments	9	3,510,460	1,272,238	3,513,629	1,275,276
Reinsurers' Share of Technical Provisions					
With-profit Insurance Contracts	11	426,307	398,516	426,307	398,516
Non-profit Insurance Contracts	11	557,805	498,256	557,805	498,256
Investment Contracts	11	539,441	302,377	539,441	302,377
Debtors					
Deposits held for Reinsurers	18	7,975	6,961	7,975	6,961
Debtors arising out of Direct Insurance Operations		10,495	6,769	10,495	6,769
Taxation recoverable		277	277	277	277
Other Debtors		2,032	3,509	1,789	3,474
Other Assets					
Tangible Assets	10	511	404	511	404
Negative Goodwill	23	(59,597)	(1,459)	(59,597)	(1,459)
Pension Scheme Surplus	13	10,441	10,205	10,441	10,205
Cash at Bank & In Hand		110,427	144,504	106,014	140,806
Prepayments & Accrued Income					
Prepayments & Accrued Interest, Dividends & Rents		295	62	295	62
		5,116,869	2,642,619	5,115,382	2,641,924

LIABILITIES
As at 31 December

	Note	Group 2019 £000	Group 2018 £000	Scottish Friendly 2019 £000	
Funds for Future Appropriations		190,890	184,653	190,890	184,653
Technical Provisions					
With-profit Insurance Contract Liabilities	11	872,042	728,859	872,042	728,859
Non-profit Insurance Contract Liabilities	11	803,899	566,628	803,899	566,628
Unit-linked Insurance Contract Liabilities	11	316,968	102,028	316,968	102,028
Investment Contract Liabilities	11	2,832,589	942,215	2,832,589	942,215
Claims Outstanding		20,246	39,568	20,246	39,568
Creditors					
Deposit Received from Reinsurers	17	42,433	44,607	42,433	44,607
Creditors arising out of Direct Insurance Operations	19	9,318	9,314	9,318	9,314
Other Creditors including Taxation & Social Security	20	25,035	22,112	24,029	21,761
Accruals and Deferred Income		3,449	2,635	2,968	2,291
		5,116,869	2,642,619	5,115,382	2,641,924

Approved by the Directors and signed on 21 April 2020 on their behalf by

- **MJ Walker**
  Chairman
- **J Galbraith**
  Director and Chief Executive

The notes on pages 52 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 Financial Reporting Standard 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 judgments 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 judgments in applying the Group's accounting policies. Such estimates and judgments 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 judgments are made, are set out below.

Critical accounting judgments

Classification of long-term contracts

The Group has exercised judgment 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 judgment is applied in assessing whether the risk so transferred is significant.

Key sources of estimation and uncertainty

Insurance contracts liabilities

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 more sensitive to changes in demographic and expense assumptions.

The cost of guarantee ('CoG') reserves balance, is increasingly significant following the take-on of the Canada Life policies. CoG is complex and material, 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 the 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 reconsidered annually, form the assumptions used to calculate the liabilities arising from these contracts. The estimates are reassessed annually. 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 2019, such claims ceded to reinsurers and reflected on the balance sheet were £983k for insurance contract liabilities (31 December 2018: £897k) and £539k (31 December 2019: £302k) 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 now in collective investment schemes and are quoted in active markets. Investments represent Scottish Friendly's most significant asset balance (£3.5bn at 31 December 2019; £1.3bn at 31 December 2018) and are key to matching insurance liabilities.

However, there is estimation uncertainty in relation £64m of investments in property funds, which are primarily open-ended and therefore carry a higher liquidity risk, and £25m 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 acquired derivative financial investments as part of the Canada Life portfolio acquisition and these are disclosed in Note 9. It did not hold any derivative financial investments at the prior year-end.

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 re-enact 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 schemes are 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 which is taken to be net asset value.

Directly held property is held for rental income and/or for capital appreciation, and us 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
Motor Vehicles	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	
	2019 £000	2018 £000	2019 £000	2018 £000	2019 £000	2018 £000
Annual	121,275	104,479	745	875	122,020	105,354
Single	3,509	5,114	–	–	3,509	5,114
	124,784	109,593	745	875	125,529	110,468

Comprising		
Premiums for participating contracts	19,859	24,667
Premiums for non-participating contracts	98,625	78,790
Premiums from linked contracts	7,045	7,011
Gross Earned Premiums	125,529	110,468
Reinsurance Premiums on Insurance Contracts	(51,699)	(44,772)
Earned Premiums, net of reinsurance	73,830	65,696

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 2019		Scottish Friendly 2018	
	Annual £000	Single £000	Annual £000	Single £000
New Business Premiums	36,441	13,800	37,737	9,120

Contributions received for Child Trust Funds, non-insurance ISAs and direct OEIC investments	Group		Scottish Friendly	
	2019 £000	2018 £000	2019 £000	2018 £000
Annual Contributions	2,442	2,187	–	–
Single Contributions	951	532	–	–

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

4. INVESTMENT INCOME

	Group		Scottish Friendly	
	2019 £000	2018 £000	2019 £000	2018 £000
Income from land & buildings	245	86	245	86
Income from financial investments held at fair value through profit and loss	27,487	26,152	27,487	26,152
Net realised gains on financial investments held at fair value through profit and loss	32,591	61,165	32,591	61,165
Investment Income	60,323	87,403	60,323	87,403

5. CLAIMS INCURRED

Group and Scottish Friendly

	Ordinary Assurance		Industrial Assurance		Total	
	2019 £000	2018 £000	2019 £000	2018 £000	2019 £000	2018 £000
Deaths	26,808	26,413	2,210	2,697	29,018	29,110
Maturities	55,720	57,709	274	665	55,994	58,374
Surrenders	29,021	11,843	1,637	526	30,658	12,369
Annuities	59,585	53,833	–	–	59,585	53,833
	171,134	149,798	4,121	3,888	175,255	153,686
Claims handling expenses					475	475
					175,730	154,161
Aggregate recoveries received from reinsurers					(80,987)	(76,786)
Net Claims Paid on Insurance Contracts					94,743	77,375

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

6. OPERATING EXPENSES AND EXCEPTIONAL COSTS

Group and Scottish Friendly

Operating Costs

	2019 £000	2018 £000
Acquisition costs	17,314	10,546
Administration expenses	11,632	8,292
Information Technology Infrastructure	2,796	4,875
Renewal commission	24,224	21,372
	55,966	45,085

Remuneration of Auditors (included within administration expenses above)

	2019 £000	2018 £000
Fees payable to the auditor for audit of annual accounts	345	151
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	17	10
Other services pursuant to legislation	91	89
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 150 (2018: 108). The aggregate payroll costs of these persons were as follows:

	2019 £000	2018 £000
Wages and salaries	6,249	4,077
Social security costs	599	430
Other pension costs	378	264
	7,226	4,771

Remuneration of Directors

Details of Directors’ remuneration are included in the Directors’ Remuneration Report on pages 38 and 39.

8. TAXATION

	Group		Scottish Friendly	
	2019 £000	2018 £000	2019 £000	2018 £000
Current tax charge	5,713	859	5,517	675
Deferred tax liabilities	5,437	(5,142)	5,437	(5,142)
Corporation Tax and irrecoverable income tax	11,150	(4,283)	10,954	(4,467)

UK corporation tax in the technical account has been calculated at a rate of 20% (2018: 20%) in accordance with rates applicable to the long term business of a friendly society.

	2019 £000	2018 £000
Transfer to fund for future appropriations	6,238	14,434
Income tax using the policyholder tax rate of 20%	1,248	2,887
Differences due to policyholder tax items	9,531	(6,824)
Under/(Over) provided in earlier years	175	(530)
Current tax year	10,954	(4,467)

The deferred tax liabilities expected to be settled after 12 months is £13.6m in the Group (2018: £2m) and £13.6m in Scottish Friendly (2018: £2m).

Corporation tax is charged at the standard rate of 19% on the profit on ordinary activities of the subsidiary SFAM £188,000 (2018: £184,086) with adjustments in respect of prior year's being £nil (2018:nil).

9. FINANCIAL INVESTMENTS

	Group				Scottish Friendly			
	Carrying Value		Cost		Carrying Value		Cost	
	2019 £000	2018 £000	2019 £000	2018 £000	2019 £000	2018 £000	2019 £000	2018 £000
Non-linked and linked financial investments								
Non-linked financial investments	1,200,925	722,727	1,032,010	577,537	1,204,094	725,765	1,034,846	580,576
Linked financial investments	2,309,535	549,511	2,047,538	402,167	2,309,535	549,511	2,047,538	402,167
Total financial investments	3,510,460	1,272,238	3,079,548	979,704	3,513,629	1,275,276	3,082,384	982,743
of which financial investments designated as:								
a) Financial investments designated at fair value	3,281,395	1,107,369	2,854,740	819,756	3,284,564	1,110,406	2,857,576	822,794
(b) Derivatives	25,218	–	27,141	–	25,218	–	27,141	–
(c) Loans and receivables	203,847	164,869	197,667	159,949	203,847	164,869	197,667	159,949
Total financial investments	3,510,460	1,272,238	3,079,548	979,704	3,513,629	1,275,276	3,082,384	982,743
Non-linked financial investments								
(a) Financial investments designated at fair value; Shares, other variable yield securities and units in OEICs and unit trusts	658,618	560,575	484,090	419,977	658,339	560,498	483,811	419,901
Debt securities and other fixed income securities	324,601	10,313	332,849	8,337	324,601	10,313	332,849	8,337
Private equity investments	81	149	658	658	81	149	658	658
Investments in Group Undertakings	–	–	–	–	3,448	3,115	3,115	3,115
Land and buildings	3,500	3,500	3,325	3,325	3,500	3,500	3,325	3,325
	986,800	574,537	820,922	432,296	989,969	577,575	823,758	435,335
(b) Derivatives								
Derivative Assets	25,218	–	27,141	–	25,218	–	27,141	–
(c) Loans and receivables								
Policyholder loans	–	4	–	4	–	4	–	4
Deposits with credit institutions	188,907	148,186	183,947	145,237	188,907	148,186	183,947	145,237
Loans secured by mortgages	–	–	–	–	–	–	–	–
	188,907	148,190	183,947	145,241	188,907	148,190	183,947	145,241
Total non-linked financial investments	1,200,925	722,727	1,032,010	577,537	1,204,094	725,765	1,034,846	580,576
Linked financial investments								
(a) Financial investments designated at fair value; Shares, other variable yield securities and units in OEICs and unit trusts	2,293,987	532,831	2,033,111	387,460	2,293,987	532,831	2,033,111	387,460
Debt securities and other fixed income securities	453	–	552	–	453	–	552	–
Land and Buildings	155	–	155	–	155	–	155	–
	2,294,595	532,831	2,033,818	387,460	2,294,595	532,831	2,033,818	387,460
(b) Derivatives								
Derivative Assets	–	–	–	–	–	–	–	–
(c) Loans and receivables								
Deposits with credit institutions	14,940	16,679	13,720	14,708	14,940	16,679	13,720	14,708
Total linked financial investments	2,309,535	549,511	2,047,538	402,167	2,309,535	549,511	2,047,538	402,167
Total Financial Investments	3,510,460	1,272,238	3,079,548	979,704	3,513,629	1,275,276	3,082,384	982,743

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 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	120,554	7,570	3,309,782
Loans and receivables;								
Deposits with credit institutions	203,560	287	–	203,847	203,560	287	–	203,847
Loans secured by mortgages	–	–	–	–	–	–	–	–
Policyholder loans	–	–	–	–	–	–	–	–
	203,560	287	–	203,560	03,560	287	–	203,847
Total financial assets				3,510,460				3,513,629
Financial instrument liabilities 2019								
Investment contract and liabilities (see Note 11)				2,832,589				2,832,589
				2,832,589				2,832,589

* During the year there has been a transfer of £46.4m from level 1 to level 2 due to the frequency of pricing received from the fund managers on property funds. In addition, a further £90.3m of Canada Life assets have been deemed to be level 2 assets.

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 unitholders at the year end.

Since the year end the L&G property fund, the Nuveen property funds and the Canada Life property funds have also suspended or placed an extended delay on transactions.

	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 2018								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	1,088,020	5,387	–	1,093,407	1,087,943	5,387	–	1,093,330
Debt securities and other fixed income securities	6,281	–	4,032	10,313	6,281	–	4,032	10,313
Private equity investments	–	–	149	149	–	–	3,264	3,264
Land and buildings	–	3,500	–	3,500	–	3,500	–	3,500
	1,094,301	8,887	4,181	1,107,369	1,094,224	8,887	7,296	1,110,407
Derivative assets	–	–	–	–	–	–	–	–
Financial assets measured at fair value through profit and loss	1,094,301	8,887	4,181	1,107,369	1,094,224	8,887	7,296	1,110,407
Loans and receivables;								
Deposits with credit institutions	164,865			164,865	164,865			164,865
Loans secured by mortgages				–				–
Policyholder loans			4	4				4
	164,865		4	164,869	164,865		4	164,869
Total financial assets				1,272,238			4	1,275,276
Financial instrument liabilities 2018								
Investment contract liabilities				(942,215)				(942,215)
				(942,215)				(942,215)

Financial instruments have been categorised between Levels 1, 2 or 3 for the fair value hierarchy on a consistent basis between 2018 and 2019. There have been no changes to the valuation methods of Levels 1, 2 or 3 in 2019 and no change in the nature of the financial instruments. All changes in fair value of financial instruments have resulted directly from trading in 2019 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:

	2019 £m	2018 £m
Derivative assets	25	–

9. FINANCIAL INVESTMENTS (continued)

Derivative financial instruments

Scottish Friendly holds interest rate swaptions to mitigate the interest rate risk associated with its non-linked business. At 31 December 2019, the outstanding contracts all mature within 8 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	Motor vehicles £000	Fixtures & fittings £000	Total £000
Cost				
At 1 January 2019	486	33	164	683
Additions	164	–	52	216
Disposals	–	–	–	–
At 31 December 2019	**650**	**33**	**216**	**899**
Depreciation				
At 1 January 2019	230	33	16	279
Charge for the year	93	–	16	109
Disposals	–	–	–	–
At 31 December 2019	**323**	**33**	**32**	**388**
Net Book Value at 31 December 2019	**327**	**–**	**184**	**511**
Net Book Value at 31 December 2018	256	–	148	404

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	2019			2018		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
With-Profits Insurance	872,042	(426,307)	445,735	728,859	(398,516)	330,343
Non-Profits Insurance	803,899	(557,805)	246,094	566,628	(498,256)	68,372
Unit Linked Insurance	316,968	-	316,968	102,028	-	102,028
Investment	2,832,589	(539,441)	2,293,148	942,215	(302,377)	639,838
Total	4,825,498	(1,523,553)	3,301,945	2,339,730	(1,199,149)	1,140,581

11. TECHNICAL PROVISIONS

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

With-Profits Insurance Contracts	Gross 2019 £000	Reinsured 2019 £000	Gross 2018 £000	Reinsured 2018 £000
1 January	728,859	(398,516)	835,723	(455,048)
Premiums received	19,859	(17)	24,667	(2,577)
Liabilities paid by claims	(99,358)	49,365	(54,302)	29,809
New Business	861	–	2,744	–
Transfer of Engagement	147,763	–	–	–
Experience variance and assumption changes	74,058	(77,139)	(79,973)	(29,300)
31 December	872,042	(426,307)	728,859	(398,516)

Non-Profit Insurance Contracts	Gross 2019 £000	Reinsured 2019 £000	Gross 2018 £000	Reinsured 2018 £000
1 January	566,628	(498,256)	563,056	(489,633)
Premiums received	98,625	(51,682)	78,790	(42,195)
Liabilities paid by claims	(50,846)	31,622	(82,242)	46,977
New Business	12,193	(11,125)	10,451	(3,680)
Transfer of Engagement	280,106	(14,631)	–	–
Experience variance and assumption changes	(102,807)	(13,733)	(3,427)	(9,725)
31 December	803,899	(557,805)	566,628	(498,256)

Unit-Linked Insurance Contracts

	Gross 2019 £000	Reinsured 2019 £000	Gross 2018 £000	Reinsured 2018 £000
1 January	102,028	–	121,030	–
Premiums received	7,045	–	7,011	–
Liabilities paid by claims	(25,050)	–	(17,142)	–
New Business	–	–	–	–
Fees deducted	(1,918)	–	(2,217)	–
Transfer of Engagement	178,458	–	–	–
Change in investment value of contracts	56,405	–	(6,654)	–
31 December	316,968	–	102,028	–

11. TECHNICAL PROVISIONS (continued)

Investment Contracts

	Gross 2019 £000	Reinsured 2019 £000	Gross 2018 £000	Reinsured 2018 £000
1 January	942,215	(302,377)	722,547	–
Premiums received	43,581	(6,967)	32,458	–
Liabilities paid by claims	(89,952)	23,958	(74,221)	–
New Business	8,011	194	6,147	–
Fees deducted	(11,756)	–	(6,110)	–
Transfer of Engagement	1,702,102	(218,113)	315,479	(315,479)
Change in investment value of contracts	238,388	(36,136)	(54,085)	13,102
31 December	2,832,589	(539,441)	942,215	(302,377)

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.

Technical Provisions (Excluding Value In Force)	2,845,279	(539,441)	964,511	(302,377)
Value of in-force business	(12,690)	-	(22,296)	-
Technical Provisions	2,832,589	(539,411)	942,215	(302,377)

12. COSTS OF BONUSES

Group and Scottish Friendly

Total bonuses attributable to the year are as follows:	2019 £000	2020 £000
Year end reversionary bonus declared (included in change in other technical provisions)	3,247	2,262
Reversionary and terminal bonuses paid (included in claims)	12,434	12,647
	15,681	14,909

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 2019, the charge included in the Technical Account relating to the employer's contributions to this scheme was £398,000 (2018: £266,000). There were no outstanding or prepaid contributions at the date of the Balance Sheet.

MGM Assurance Staff Pension Plan

The Company 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 the Company and is supervised by independent trustees. 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.

The Company 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.

13. PENSIONS (continued)

Under the current Recovery Plan, dated October 2016, the Company is paying contributions of £226,667 per month for a period of 2 years and 6 months from 1 November 2016 to 30 April 2019.

A formal actuarial valuation was carried out as at 31 December 2018. The results of that valuation have been projected to 31 December 2019 with allowance for benefit cash flows and using the assumptions set out below. 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:	2019 £000	2018 £000
Defined benefit obligation	(110,167)	(97,093)
Fair value of plan assets	120,608	107,298
Net defined benefit asset	10,441	10,205
Restriction on asset recognised	–	–
Net amount recognised at year end (before any adjustment for deferred tax)	10,441	10,205

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.

	2019 £000	2018 £000
Service cost:		
Current service cost (net of employee contributions)	–	–
Administration expenses	–	–
Loss/(gain) on plan introductions, changes, curtailments and settlements	–	1,623
Net interest (credit)/expense	(324)	(9)
Charge/(credit) recognised in profit of loss	(324)	1,614
Remeasurements of the net liability:		
Return on scheme assets (excluding amount included in net interest expense)	(10,786)	5,129
Actuarial (gains)/losses	13,594	(15,224)
Adjustment for the restrictions on the asset recognised	–	
(Credit) recorded in other comprehensive income	2 ,808	(10,095)
	–	
Total defined benefit cost	2,484	(8,481)

13. PENSIONS (continued)

The principal actuarial assumptions used were:

	2019	2018
Liability discount rate	2.05%	2.80%
Inflation assumption – RPI	3.15%	3.15%
Inflation assumption – CPI	2.15%	2.15%
Revaluation of deferred pensions:		
GMP	Fixed rate	Fixed rate
Excess over GMP	2.15%	2.15%
Increases for pensions in payment:		
Pre 88 GMP	–	–
Post 88 GMP	3.00%	3.00%
Excess over GMP (RPI capped at 5%)	3.05%	3.05%
Proportion of employees opting for early retirement	–	–
Proportion of employees commuting pension for cash	–	–
Expected age at death of current pensioner at age 65:		
Male aged 65 at year end:	88.3	88.2
Female aged 65 at year end:	90.4	90.3
Expected age at death of future pensioner at age 65:		
Male aged 45 at year end:	90.0	89.9
Female aged 45 at year end:	91.6	91.5

Reconciliation of Plan assets and liabilities	Assets £000	Liabilities £000	Total £000
At start of period	107,298	(97,093)	10,205
Benefits paid	(3,194)	3,194	–
Administration expenses	–	–	–
Current service cost	–	–	–
Contributions from the employer	2,720	–	2,720
Contributions from employees	–	–	–
Interest income/(expense)	2,998	(2,674)	324
Return on assets (excluding amount included in net interest expense)	10,786	–	10,786
Actuarial gains	–	(13,594)	(13,594)
(Loss) on plan introductions and changes	–	–	–
Gain/(loss) on curtailments	–	–	–
Assets distributed/liabilities extinguished on settlements	–	–	–
Assets acquired/liabilities assumed in a business combination	–	–	–
At end of period	120,608	(110,167)	10,441

13. PENSIONS (continued)

The return on Plan assets was:

	2019 £000	2018 £000
Interest income	2,998	2,713
Return on plan assets (excluding amount included in net interest expense)	10,786	(5,129)
Total return on plan assets	13,784	(2,416)

The major categories of Plan assets are as follows:

	2019 £000	2018 £000
UK Equities	3,077	1,518
Overseas Equities	14,605	3,707
Corporate Bonds	11,050	
Gilts	12,694	11,606
Index Linked	5,021	73,456
Property	3,903	3,899
Commodities	1,980	1,955
Hedge Fund	15,493	10,093
Cash	11,833	1,064
LDI	30,663	
Alternatives	10,289	
Total market value of assets	120,608	107,298

14. WITH PROFITS ACTUARY

Group and Scottish Friendly

Mr DJ Lechmere of OAC plc served as the With-Profits Actuary for the period between 1 January 2019 and 24 May 2019. 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 Lechmere 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 OAC plc for professional services which amounted to £63,659 (2018: £106,648).

Mr S Makin of Hymans Robertson LLP served as the With-Profits Actuary for the period between 29 May 2019 and 31 December 2019. 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 £641,091(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 £51,328 (2018: £52,056).

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 (established as a result of transfer from Canada Life Limited).

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 honouring these guarantees is quantified as part of the liability for participating contracts; and
- guaranteed annuities. 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

	2019			2018		
	Main fund £000	Closed sub-funds £000	Total £000	Main fund £000	Closed sub-funds £000	Total £000
Total available capital resources	129,890	38,948	168,838	79,048	31,695	110,743

The capital resources in 2019 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)

	2019 £000	2018 £000
Opening capital resources	110,743	158,660
Prior year adjustments	27	(23,748)
Increase/(Decrease) in Current Assets	2,211,164	(156,352)
(Increase)/Decrease in Technical Provisions	(2,165,369)	157,401
(Increase)/Decrease in Current Liabilities	18,543	(15,125)
Total	175,108	151,086
(Decrease) in ring-fencing of available capital	(6,270)	(40,343)
Closing capital resources	168,838	110,743

Note: the opening capital resources are consistent with those shown in the report and accounts as at 31 December 2019. 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

	2019 £000	2018 £000
Own Funds	168,838	110,743
SCR	99,853	58,820
Solvency Ratio	169%	188%

(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.

	2019 £000	2018 £000
Collateral deposits for:		
“Select” annuity (Hannover Re)	36,598	38,327
“Standard” annuity (RGA)	5,835	6,280
	42,433	44,607

18. DEPOSITS HELD FOR REINSURERS

The “Standard” and “Select” annuity products written in the past by 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.

	2019 £000	2018 £000
Collateral deposits for:		
Longevity Swap (Pacific Life Re)	7,975	6,961
	7,975	6,961

19. CREDITORS ARISING OUT OF DIRECT INSURANCE OPERATIONS

Group and Scottish Friendly

	2019 £000	2018 £000
Due to reinsurers	2,345	1,907
Due to intermediaries	6,973	5,435
Other insurance payables	–	1,972
	9,318	9,314

20. OTHER CREDITORS INCLUDING TAXATION AND SOCIAL SECURITY

	Group		Scottish Friendly	
	2019 £000	2018 £000	2019 £000	2018 £000
Taxation	19,909	2,667	19,843	2,483
Trade Creditors	132	188	132	188
Investments Creditors	102	13,230	102	13,230
Other payables	2,980	3,895	2,040	3,728
HMRC payments PAYE and VAT	1,912	2,132	1,912	2,132
	25,035	22,112	24,029	21,761

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 37, 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. In addition, the directors have considered the impact of COVID-19 as outlined in Note 24.

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 Chief Actuary, 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.

	2019 Impact on the FFA £m	2018 Impact on the FFA £m
Increase in expenses by 10%	(13.5)	(11.7)
Increase in assurance mortality rates by 15%	(2.5)	(1.6)
Reduction in persistency by 10%	(6.0)	(5.3)

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.

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 below, 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 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

Group 2018

	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	99,254	272,191	37,195	117,709	6	–	526,355
Cash and cash equivalents	–	101,667	28,737	14,100	–	–	144,504
Reinsurers' share of technical provisions	–	498,787	–	–	700,362	–	1,199,149
Other assets	–	6,961	–	–	8,819	10,948	26,728
Linked assets not subject to credit risk	–	–	–	–	–	455,866	455,866
Non-linked assets not subject to credit risk	–	–	–	–	–	290,017	290,017
Total	99,254	879,606	65,932	131,809	709,187	756,831	2,642,619

The derivative investments portfolio obtained as part of the Canada Life acquisition on 1st November 2019 require third parties to pledge collateral for the derivative assets. Such arrangements are in the process of being put in place as at 31st December 2019. The collateral is to be 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 (2018: £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 £195,320,000 (2018: £180,793,000) and £2,539,146,000 (2018: £739,629,000) respectively.

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

	Group		Scottish Friendly	
	2019 £000	2018 £000	2019 £000	2018 £000
Other financial liabilities	100,481	118,236	98,994	117,541

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
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
2018						
Liabilities subject to liquidity risk:						
Non-profit (insurance)	66,223	123,352	165,152	187,695	184,104	726,526
With-Profits (insurance)	381,970	348,920	139,085	93,843	166,885	1,130,703
Unit Linked	100,297	–	–	–	–	100,297
Investment	926,179	–	–	–	–	926,179
Other Liabilities	108,031	–	–	–	–	108,031
Total	1,582,700	472,272	304,237	281,538	350,989	2,991,736

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.

	2019 Impact £m	2018 Impact £m
Equity Fall	(12.7)	(9.7)
Property Fall	(0.8)	(0.6)
Interest Rate Fall	(1.2)	(2.5)
Interest Rate Rise	3.5	5.1

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:

	2019 £m	2018 £m
Financial assets/liabilities measured as fair value through profit or loss		
Derivative financial instruments	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 2019, the outstanding contracts all mature within 8 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. TRANSFER OF ENGAGEMENTS

Acquisition of Canada Life Portfolio

On 1 November 2019, Scottish Friendly Assurance Society Limited Completed the Part VII transfer of a book of life and pensions business from Canada Life Limited. The business consists of 90,000 scheme members with assets totalling £2.4bn. The transfer was carried out in accordance with Part VII of the Financial Services and Markets Act 2000. No consideration was paid for the acquisition upon completion of the Part VII transfer. Scottish Friendly Assurance Society Limited has used acquisition accounting to account for the purchase.

The following table summarises the fair value of the assets acquired and liabilities assumed upon completion of the Part VII transfer on 1 November 2019:

	Book Value £000	Adjustments £000	Fair Value £000
ASSETS			
Other Financial Investments	378,266	–	378,266
Assets held to cover linked insurance and investment liabilities	1,704,101	–	1,704,101
Reinsurer's share of liabilities	232,744	–	232,744
Debtors	3,480	–	3,480
Cash	65,184	–	65,184
LIABILITIES			
With-profit insurance contract liabilities	(147,763)	–	(147,763)
Non-profit insurance contract liabilities	(280,106)	–	(280,106)
Unit-linked insurance contract liabilities	(178,458)	–	(178,458)
Investment contract liabilities	(1,702,102)	–	(1,702,102)
Claims Outstanding	(6,233)	–	(6,233)
Other Creditors	(4,719)	–	(4,719)
Net assets/(liabilities) acquired	64,394	–	64,394
Cost of acquisition			(5,254)
(Negative) goodwill arising on acquisition			(59,140)

Negative goodwill is expected to be recognised in the profit or loss over the next 10 years, being the expected run-off period of the acquired contracts.

The premiums from the business acquired from Canada Life Limited included in the income statement for 2019 was £2.5m. In addition, this business also contributed £3.9m to the surplus for the year.

23. NEGATIVE GOODWILL

	2019 £'000	2018 £'000
Carrying amount at the beginning of the period	(1,459)	–
Changes arising from new business combinations	(59,140)	(1,459)
Amortisation	1,002	–
Carrying amount at the end of the period	(59,597)	1,459

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.

24. NON-ADJUSTING POST BALANCE SHEET EVENTS

COVID-19 has caused disruption to businesses and economic activity which has been reflected in recent fluctuations in global stock markets since the year end.

The directors consider the emergence of COVID-19 as a pandemic, and the associated government measures both in the UK and overseas in response, as a non-adjusting post balance sheet event.

In this environment, the Group has adjusted its client service and operational capability, and has upscaled its ability to deliver core services from the home environment, and have executed plans to minimise the risk of transmission from within the Group's office space.

This strength of the capital and liquidity 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 year end, Scottish Friendly remains well capitalised. The solvency and liquidity position is being monitored frequently, with appropriate actions taken to protect the long-term interest of policyholders and the overall capital and liquidity position of Scottish Friendly.

Scottish Friendly continues to have a capital position in excess of the levels required by the regulations, and remain above the minimum tolerance levels set for Scottish Friendly by the Board, which themselves are designed to provide a strong level of protection for policyholders.

To support the continuation of this position, certain actions have been taken to improve the solvency position and to reduce exposure to further market falls. These have focused on the areas of the business with the greatest exposure to market risks, particularly the business held in the M&GM sub-fund, and have included de-risking of certain assets and additional matching activity.

The overall financial impact of COVID-19 on the financial results cannot be reliably and comprehensively estimated at this time. However, COVID-19 has in particular affected some key investment market indicators that can have a material effect on the Group's financial results in excess of the sensitivities shown in Note 21 on page 81. Applying a consistent methodology, it is estimated that when considering the 25% decrease in equity prices since the year end date (based on the FTSE All Share Total Return Index as at 31 March 2020), this would reduce the Funds for Future Appropriations by £8.1 million (unaudited); and for the 0.47% decrease in interest rates (based on the Solvency II interest rate term structure, 15 year duration), since the year end date, this would reduce the Funds for Future Appropriations by £2.1 million (unaudited).

Finally, the Group reinsures a significant level of its insurance risks to a number of reinsurers, and maintains an appropriate level of matching of its assets and related liabilities. At this time, Scottish Friendly has not seen any impact on the credit standing of its reinsurers or of the Group's access to such markets.

Further consideration to impacts of COVID-19 is given in the Strategic Report on pages 7 to 15.

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

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