Head Office: Galbraith House, 16 Blythswood Square, Glasgow G2 4HJ.

Scottish Friendly

Solvency and Financial Condition Report 2022

Contents

SUMMARY

Scottish Friendly Assurance Society Limited (Scottish Friendly) is a modern financial mutual based in Glasgow, with roots that stretch back to 1862. Comprising Scottish Friendly Assurance Society ('SFAS'), Scottish Friendly Asset Managers ('SFAM') and a number of smaller subsidiaries, the Group develops and administers a range of life and investment products including ISAs. These products are marketed under the Scottish Friendly brand or are "white labelled" by other financial services providers.

Today, as at 31 December 2022, the Group has assets under management of £4.5 billion (2021: £5.4 billion) and has an estimated 814,000 members (2021: 776,000).

Over the past decade, Scottish Friendly has significantly restructured its business, reducing relative administration costs and maintaining efficient acquisition costs. The Group follows a three-part growth strategy of organic growth, mergers and acquisitions and business process outsourcing.

Despite the challenging external business environment, with rising inflation and volatile investment markets, the business remains well-capitalised, reflecting the strength of the capital position and actions taken to manage that position. The solvency and liquidity positions are monitored frequently, and actions taken, as appropriate, 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 both the levels required by the regulations, which themselves are designed to provide a strong level of protection for policyholders, and the minimum tolerance levels above this amount as set by the Board.

Mergers and consolidation within the life insurance sector is one of the main elements of Scottish Friendly's strategy and is important in producing long term economies of scale. 2022 saw Scottish Friendly continue to embed the significant portfolio of life and pensions policies that transferred from Canada Life Limited (CLL) in 2019. Scottish Friendly remains active in the market, and will consider future mergers and acquisitions where these enhance value for our members.

Since 2012, Scottish Friendly's organic growth has been founded on the introduction of innovative and affordable ISA investments via the Group's My Plans platform, including a multi-award-winning Junior ISA for children, and a range of protection products. Scottish Friendly has continued to deliver sales and increase membership as a result of strong e-business and direct marketing and major collaborations with companies like the Neilson Financial Services and Guardian Financial Services. The success of this strategy was reflected in another year of strong financial results, with Scottish Friendly continuing to deliver record total sales of £47.7m APE[1] (2021: £46.9m).

During 2022 Scottish Friendly won a record number of industry awards, recognising its achievements once again across a number of key areas within the financial services industry. These included Best Junior ISA Provider at the Investment Life and Pensions Moneyfacts awards and Best UK Mutual Insurer at the Capital Finance International awards, both of which were won for the fifth consecutive year. For the second consecutive year Scottish Friendly was awarded Best Junior ISA Provider and Most Innovative Mutual Insurer at the Global Brands Magazine awards, as well as four accolades at the Global Business Review Magazine awards, three accolades at the World Business Outlook awards, with double success at both the International Business Magazine and World Business Stars Magazine awards.

This growth has been built on the foundation of a robust capital position, with a solvency ratio[2] of 204% (2021: 174%) under the Solvency II regulations. This ratio has remained resilient in light of continued volatility in financial markets and shows a significant excess over the required minimum. Our solvency ratio demonstrates that, even in an extreme 1-in-200 year scenario, we expect to have enough capital to meet our liabilities to policyholders.

This report is the Solvency Financial Condition Report (SFCR) for Scottish Friendly Assurance Society Limited. It is a solo report covering Scottish Friendly Assurance Society Limited's activities.

1 Annual Premium Equivalent, the industry standard measure of premium volumes, calculated as the annual amount of regular premiums plus one tenth of the single premiums on business written during the year.

2 The solvency ratio is the Own Funds divided by the Solvency Capital Requirement (SCR)

DIRECTORS' RESPONSIBILITIES STATEMENT

IN RESPECT OF THE SOLVENCY AND FINANCIAL CONDITION REPORT ("SFCR")

The Directors are responsible for preparing the Solvency and Financial Condition Report ('SFCR') in accordance with applicable law and regulations.

The PRA Rulebook for Solvency II firms in Rule 6.1(2) and Rule 6.2(1) of the Reporting part requires that Scottish Friendly must have in place a policy of ensuring the ongoing appropriateness of any information disclosed and that Scottish Friendly must ensure that its SFCR is approved by the Directors.

Each Director certifies that:

a) the Solvency and Financial Condition Report ("SFCR") has been properly prepared in all material respects in accordance with the PRA rules and Solvency II Regulations;

b) throughout the financial year in question, the Company has complied in all material respects with the requirements of the PRA rules and Solvency II Regulations as applicable to the Company; and

c) it is reasonable to believe that, at the date of the publication of the SFCR, the Company has continued so to comply, and will continue so to comply in future.

By order of approval of the Board.

Stephen McGee
Director

4 April 2023

Alan Rankine
Director

4 April 2023

Report of the external independent auditors to the Directors of Scottish Friendly Assurance Society Limited

('the Company') pursuant to Rule 4.1 (2) of the External Audit Part of the PRA Rulebook applicable to Solvency II firms

Report on the Audit of the Relevant Elements of the Solvency and Financial Condition Report

Opinion

Except as stated below, we have audited the following documents prepared by the Society as at 31 December 2022:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report of the Society as at 31 December 2022, ('**the Narrative Disclosures subject to audit**'); and
- Company templates S.02.01.02, S.12.01.02, S.23.01.01, S.25.01.21 and S.28.01.01 ('**the Templates subject to audit**').

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the '**relevant elements of the Solvency and Financial Condition Report**'.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on the **Other Information** which comprises:

- The 'Summary', 'Business and performance', 'System of governance' and 'Risk profile' elements of the Solvency and Financial Condition Report;
- Company templates S.05.01.02;
- The written acknowledgement by management of their responsibilities, including for the preparation of the Solvency and Financial Condition Report ('**the Responsibility Statement**').

In our opinion, the information subject to audit in the relevant elements of the Solvency and Financial Condition Report of the Society as at 31 December 2022 is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) including ISA (UK) 800 and ISA (UK) 805, and applicable law. Our responsibilities under those standards are further described in the *Auditors' Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report* section of our report. We are independent of the Society in accordance with the ethical requirements that are relevant to our audit of the Solvency and Financial Condition Report in the UK, including 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 believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusions Relating to Going Concern

Our evaluation of the Directors' assessment of the Company'sSociety's ability to continue to adopt the going concern basis of accounting included:

- Obtained management's going concern assessment and challenged the key observations arising with respectrationale for downside scenarios adopted and material assumptions made using our knowledge of the Group's business performance, review of regulatory correspondence and obtaining further corroborating evidence;
- Considered management's assessment of the regulatory solvency coverage and liquidity in management's future forecast; and
- Considered information obtained during the course of the audit and publicly available market information to identify any evidence that evaluation]would contradict management's assessment of going concern.

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the Company's ability to continue as a going concern for a period of at least twelve months from the date on which the Solvency and Financial Condition Report is authorised for issue.

In auditing the Solvency and Financial Condition Report, we have concluded that the directors' use of the going concern basis of accounting in the preparation of the Solvency and Financial Condition Report is appropriate.

However, because not all future events or conditions can be predicted, this conclusion is not a guarantee as to the Society's ability to continue as a going concern.

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

Emphasis of Matter - Basis of Accounting

We draw attention to the 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report, which describe the basis of accounting. The Solvency and Financial Condition Report is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The Solvency and Financial Condition Report is required to be published, and intended users include but are not limited to the Prudential Regulation Authority. As a result, the Solvency and Financial Condition Report may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

Other Information

The Directors are responsible for the Other Information.

Our opinion on the relevant elements of the Solvency and Financial Condition Report does not cover the Other Information and we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the Solvency and Financial Condition Report, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the relevant elements of the Solvency and Financial Condition Report, 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 relevant elements of the Solvency and Financial Condition Report 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. We have nothing to report in this regard.

Responsibilities of Directors for the Solvency and Financial Condition Report

The Directors are responsible for the preparation of the Solvency and Financial Condition Report in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations.

The Directors are also responsible for such internal control as they determine is necessary to enable the preparation of a Solvency and Financial Condition Report that is free from material misstatement, whether due to fraud or error.

Auditors' Responsibilities for the Audit of the Relevant Elements of the Solvency and Financial Condition Report

It is our responsibility to form an independent opinion as to whether the information subject to audit in the relevant elements of the Solvency and Financial Condition Report is prepared, in all material respects, in accordance with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

Our objectives are to obtain reasonable assurance about whether the relevant elements of the Solvency and Financial Condition Report are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but it 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 decision making or the judgement of the users taken on the basis of the Solvency and Financial Condition Report.

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

Based on our understanding of the Society/industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of regulatory principles, such as those governed by the PRA and the Financial Conduct Authority (FCA) and we considered the extent to which non-compliance might have a material effect on the Solvency and Financial Condition Report. We also considered those laws and regulations that have a direct impact on the Solvency and Financial Condition Report such as the applicable Solvency II regulations. We evaluated management's incentives and opportunities for fraudulent manipulation of the Solvency and Financial Condition Report (including the risk of override of controls), and determined that the principal risks were related to posting inappropriate adjustments between UK GAAP and Solvency II values and management bias in accounting estimates and judgmental areas of the Solvency and Financial Condition Report, such as the best estimate liabilities. Audit procedures performed included:

- Discussions with the Board, management, Internal Audit and senior management involved in the Risk and Compliance function, including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;
- Evaluation and testing of the operating effectiveness of management's controls designed to prevent and detect irregularities;
- Reading key correspondence with and reports to the PRA and the FCA in relation to compliance with laws and regulations;
- Reviewing relevant meeting minutes including those of the Audit Committee, the Risk Committee and the Technical Provisions Committee;
- Reviewing data regarding policyholder complaints, the Society's register of litigation and claims, Internal Audit reports, compliance reports in so far as they related to non-compliance with laws and regulations and fraud;
- Procedures relating to balances that include accounting estimates and judgements, such as the valuation of best estimate liabilities; and
- Identifying material adjustments to derive the Solvency II financial information from the statutory financial statements and assessing for indicators of material non-compliance with Solvency II regulations.
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There are inherent limitations in the audit procedures described above. We are less likely to become aware of instances of non-compliance with laws and regulations that are not closely related to events and transactions reflected in the Solvency and Financial Condition Report. Also, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

A further description of our responsibilities for the audit is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this Report

This report, including the opinion, has been prepared for the Board of Directors of the Society in accordance with External Audit rule 2.1 of the Solvency II firms Sector of the PRA Rulebook and for no other purpose. We do not, in providing this report, accept or assume responsibility for any other purpose or to any other party save where expressly agreed by our prior consent in writing.

Report on Other Legal and Regulatory Requirements

In accordance with Rule 4.1 (3) of the External Audit Part of the PRA Rulebook for Solvency II firms we are also required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of the Society's statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

PricewaterhouseCoopers LLP
Chartered Accountants

7 More London Riverside
London
SE1 2RT

4 April 2023

A

Business and Performance

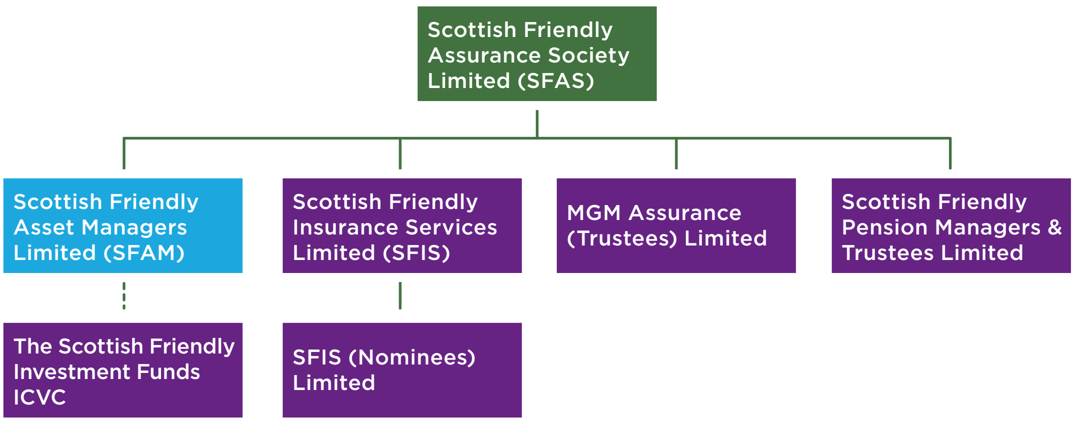
A.1 Business

Scottish Friendly is an incorporated friendly society, a type of mutual, and consequently there are no shareholders in Scottish Friendly. The organisational structure of the business is detailed below.

Green denotes insurance company, subject to full Senior Managers & Certification Regime ("SM&CR") rules.

Blue denotes a firm regulated in accordance with the Prudential Sourcebook for Investment Firms ('IFPRU'), in scope for SM&CR.

Purple denotes unregulated entity not in scope for SM&CR.



Scottish Friendly offers a range of life insurance products to policyholders in the United Kingdom. The main products are whole of life policies, endowment assurances, term assurance and ISAs.

The Scottish Friendly balance sheet is split between its Main Fund, which is open to new business, and five sub funds to the Main Fund, which are closed to new business. The closed sub funds are the Rational Shelley sub fund, London, Aberdeen and Northern Mutual Assurance Society (LANMAS) sub fund, the Scottish Legal Life sub fund, the Marine & General Mutual (M&GM) sub fund and the Manulife sub fund.

Limited volumes of legacy products were sold across Europe either by Scottish Legal Life and M&GM and, where relevant, premiums are still received for these.

Scottish Friendly is authorised and regulated by the Prudential Regulatory Authority ("PRA"), which is located at 20 Moorgate, London EC2R 6DA.

Scottish Friendly is also regulated by the Financial Conduct Authority ("FCA"), which is located at 12 Endeavour Square, London, E20 1JN.

Scottish Friendly's auditor is PricewaterhouseCoopers LLP, whose office is 7 More London Riverside, London, SE1 2RT.

A.2 Underwriting Performance

The following table illustrates Scottish Friendly's performance over 2022, as reflected in the 2022 Annual Report and Accounts:

Technical Account - Long Term Business **For year ended 31 December**	**2022 £000**	**2021 (retated) £000**
Earned Premiums	198,752	188,505
Reinsurance Premiums	(72,475)	(67,692)
Earned Premiums, Net of Reinsurance	126,277	120,813
Investment Income	55,042	237,354
Unrealised Gains/(Losses) on Investments	(458,002)	110,394
Other Technical Income	33,001	30,698
Release of Negative Goodwill	6,060	6,060
	(237,622)	**505,319**
Claims Incurred	261,236	269,467
Reinsurance Claims	(107,502)	(98,955)
Net Claims Incurred	153,734	170,512
Change in Long-term Business Provision	(305,980)	(80,303)[1]
Change in Technical Provisions for Linked Liabilities	(162,781)	310,203[1]
Operating Expenses	90,583	78,159
Investment Expenses & Charges	3,409	3,255
Other Technical Charges	1,190	861
Tax attributable to Long Term Business	(36,869)	16,594
Actuarial (Gain)/Loss re pension scheme	15,156	(16,742)
Transfer to the Fund for Future Appropriations	3,936	22,780[1]
	(237,622)	**505,319**

1 Values have been restated. Please see note 37 in the Scottish Friendly Annual Report and Accounts for more details.

Scottish Friendly writes four lines of business as detailed below:

- Insurance with participation
- Index Linked and Unit Linked
- Other Life Insurance
- Health Insurance business

The table below illustrates Scottish Friendly's premiums, claims and expenses split by Solvency II lines of business for the periods ended 31 December 2022 and 31 December 2021.

2022	Insurance with participation £000	Index Linked & Unit Linked Insurance £000	Other Life Insurance £000	Health Insurance £000	Total
Gross Premiums	44,620	7,817	143,422	2,893	198,752
Gross Claims	92,399	60,944	104,832	3,061	261,236
Expense	10,071	1,764	81,503	653	93,992

2021	Insurance with participation £000	Index Linked & Unit Linked Insurance £000	Other Life Insurance £000	Health Insurance £000	Total
Gross Premiums	47,256	9,662	128,710	2,877	188,505
Gross Claims	117,826	58,481	89,488	3,672	269,467
Expense	3,873	2,636	74,177	785	81,471

A.3 Investment Performance

The return attributed to the asset shares within the Scottish Friendly with-profits Main Fund for 2022 was (17.9)% (2021: 7.5%) reflecting the challenging external environment for investments throughout the year. An additional 1.2% uplift was allocated to with-profits policies in the Main Fund to reflect their share of miscellaneous surplus generated.

The Group assets under management decreased to £4,519 million (2021: £5,378 million), reflecting negative investment returns over the year, as well as outflows from policyholder claims, surrenders and maturities. This was partially offset by inflows from new business sales.

Financial investments are recognised at fair value through profit or loss. Derivatives are recognised at their marked to market value.

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.

The following table illustrates Scottish Friendly's investment performance over 2022, as reflected in the annual report and accounts. The significant unrealised losses in the year reflect the challenging market environment.

	2022 £000	2021 £000
Income from land & buildings	100	71
Income from other investments	67,011	58,815
Net gains on the realisation of investments	(12,069)	178,468
Unrealised Gains/(Losses) on investments	(458,002)	110,394
	(402,960)	**347,748**

A.4 Performance of Other Activities

Other technical income predominantly comprises fee income. Fee income is charged to policyholders for administration services and investment management services. These fees are recognised in the period over which the services are performed.

In 2022, the total other technical income was £33.0m, compared to £30.7m in 2021. Of the 2022 total, £26.4m relates to fee income (2021: £28.1m).

A.5 Any Other Material Information

There is no other material information to provide in this report.

B
System of Governance

B.1 General Information on the System of Governance

As a mutual organisation, the Board of Management is responsible to the members for the performance of Scottish Friendly, and the service that is provided. This accountability is exercised through the Delegates system of member representation.

Scottish Friendly operates a delegate system to ensure that it engages with, and is accountable to, its members. Scottish Friendly has 30 delegate positions, each representing one of five geographical electoral districts (Scotland, Northern Ireland, North of England, South of England & Wales and Republic of Ireland). In addition to any vacancies that arise from time to time, one third of delegates have to retire in rotation each year and may offer themselves for re-election. The system allows members to have their views represented at the Annual General Meeting through their representative delegate (typically the delegate closest to them geographically).

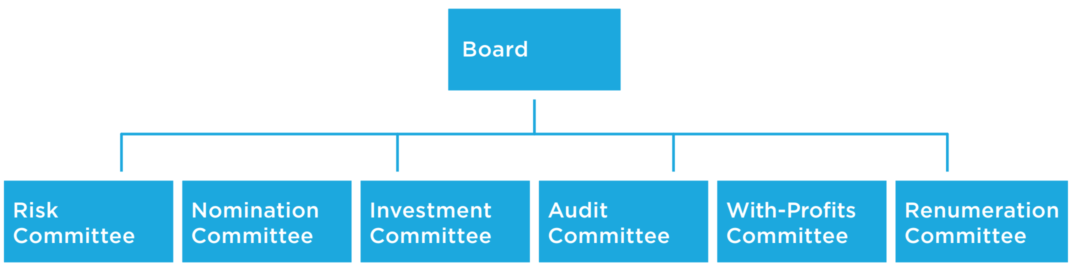
The Board Members and Scottish Friendly Executives who have duties in relation to Scottish Friendly's subsidiaries are fully responsible for ensuring that they are managed to the same high standards and principles set out by Scottish Friendly.

Responsibilities have been allocated to senior management in accordance with the SM&CR. The functional structure of Scottish Friendly and roles and responsibilities of key function holders are set out in Appendices F1 and F2.

As a mutual, Scottish Friendly has no shareholders.

Internal Control Framework

The Board is responsible for directing the affairs of Scottish Friendly. In addition to the principles of prudent management, there are several specific powers given to the Board, which are defined in the Scottish Friendly Rules. 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 out with 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 committee and governance structure is set out in detail in Appendix F1. The high-level structure is set out above and the responsibilities of the Committees are as follows:

Risk Committee

- Provides focused support and advice on risk strategy, assisting the Board in reviewing\ the systems for managing all aspects of business risk.
- Takes account of the most significant issues and risks, both operational and financial, likely to impact on Scottish Friendly's customers and the Group's financial statements.
- Reviews, challenges and approves the Risk Appetite Methodology and recommends the Statements to the Board for approval, including monitoring measures with limits and triggers that are the basis for regular Own Risk and Solvency Assessment (ORSA) reporting.
- Shapes 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 and reviews the design and execution of stress and scenario testing.
- Ensures there is a satisfactory framework in place with appropriate metrics for identifying and managing all aspects of risk within the business and to keep under review the steps taken by management to monitor, manage and mitigate risk.
- Receives regular reports from Executive Risk Committee and Risk and Compliance functions outlining the key prudential and conduct risks facing Scottish Friendly and the controls and actions in place to mitigate their impacts.

Nomination Committee

- Ensures that plans are in place for orderly succession for appointments to the Board.
- 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.
- Considers the overall balance of skills, experience and knowledge to ensure that Directors bring informed and independent judgement to the Board.
- Ensures that Scottish Friendly's employee policies are applied in Board nomination matters.

Investment Committee

- Oversees Scottish Friendly's investment holdings and performance on behalf of the Board.
- Makes decisions on asset allocation and strategy of the Scottish Friendly funds in line with the liabilities, relevant risk appetite and parameters established by the Board or by the relevant fund objective.
- Monitors risk appetite, investment parameters and fund objectives, making recommendations to the Board as appropriate.

Audit Committee

- Reviews internal control systems, including internal financial controls and ensures that these continue to be effective; advises the Risk Committee as appropriate of any concerns regarding the effectiveness of the current control framework.
- Considers the Audit Plan which highlights key judgement areas and summarises changes in reporting requirements.
- Reviews the annual financial statements and regulatory returns and approves these for submission to the Board.
- Approves the internal audit programmes and receives regular process reports from internal audit and ensures that recommendations made are followed up. Also monitors co-ordination between the internal and external auditors and ensures that the Internal Audit Function (IAF) is adequately resourced and has appropriate standing within the organisation.
- Assesses the effectiveness of the internal and external audit processes through the reporting that it receives from the respective auditors who are present at each Committee meeting.
- Provides recommendations to the Board in relation to the appointment of the external auditors.
- With-Profits Committee
- Provides recommendations and advice to the Board on the way each with-profits fund is managed.
- Considers compliance with the principles and practices set out in the relevant Principles and Practices of Financial Management (PPFM).
- Provides recommendations to the Board relating to changes that would result in a revision to the PPFM(s).
- Provides advice to the Board as to whether Scottish Friendly has effectively addressed the conflicting rights and interests of with-profits policyholders and other policyholders or stakeholders.
- Considers other issues which with-profits policyholders might reasonably expect the With-Profits Committee to be involved in, including bonus setting, the development of run-off plans and the identification of surplus within the various funds.
- Remuneration Committee

- Reviews the remuneration of the Chair and other Non-Executive Directors and determines appropriate levels of Executive Management remuneration.

There were no changes to the structure of the internal control framework over 2022.

In April 2022, Stephen McGee was appointed CEO and there have been a number of further changes to individuals performing senior management roles throughout 2022. Details of the individuals performing key functions as at 31 December 2022 are set out in Appendix F2.

Remuneration Policy

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 in 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 increasing growth and cost efficiencies while generating longer term value for members. Payments are capped at 100% of salary. In line with the relevant Solvency II requirements, 40% of bonus payments may require to be deferred for three years, if applicable.

The Executive Directors are entitled to a company car and healthcare insurance.

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

Fees for the Chair are set by the Committee in his absence. Fees for Non-Executive Directors are monitored and reviewed annually with changes effective from 1 May through approval by the Executive Directors and the Chair. Fees are designed to recognise the responsibilities of Non-Executive Directors and to attract individuals with the necessary skills and experience to contribute to the future development of Scottish Friendly.

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

The aggregate premiums payable for the year by nine Directors in respect of Scottish Friendly's products amounted to £55,912 (2021: £71,926).

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

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 an assumed 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.

Changes to the System of Governance

There were no significant changes to the system of governance over 2022.

Assessment of the adequacy of Systems of Governance

The systems of governance in place within Scottish Friendly are assessed to be effective. The Board reports on its effectiveness as part of the Directors' Report in the Annual Report and Accounts. Where relevant, external support has been obtained to assess effectiveness. In addition, each Committee (where appropriate) completes an annual self-assessment to consider how effectively it has discharged its terms of reference, as well as more generally how effectively it has operated over the period. In addition, the Risk Committee undertakes an assessment of the effectiveness of the Risk Function and the Audit Committee undertakes an assessment of the effectiveness of the Internal Audit Function. This ensures that adequate and effective governance and oversight arrangements are in place.

B.2 Fit and Proper requirements

Scottish Friendly has been subject to the SM&CR since December 2018. The aim of the SM&CR is to reduce harm to consumers and strengthen market integrity by making individuals more accountable for their conduct and competence.

The SM&CR seeks to ensure that senior persons, who are responsible for overseeing and managing insurance firms, or who have responsibility for other key functions at those firms, will behave with integrity, honesty and skill.

The SM&CR consists of 3 parts:

- The Senior Managers Regime, which focuses on individuals who hold key roles within Scottish Friendly;
- The Certification Regime, which applies to other staff who could pose a risk of significant harm to Scottish Friendly or any of its customers; and
- The Conduct Rules, which are high level requirements that hold individuals to account.

Scottish Friendly has implemented appropriate processes and controls to comply with the SM&CR. All members of staff are provided with appropriate annual training on the Conduct Rules, how these apply to them and the standards of behaviour Scottish Friendly expects.

The responsibilities of Scottish Friendly`s senior managers, and those of key function holders (KFH's) within the business, are documented in Scottish Friendly`s Management Responsibilities Map and Manual.

Scottish Friendly ensures that individuals subject to the SM&CR are fit and proper to do their jobs. This requirement to assess fitness and propriety applies to:

- Senior Managers
- Individuals subject to the Certification Regime (including KFH`s)

The fitness and propriety of an individual is performed before they commence the role, and thereafter on an annual basis.

In assessing whether an individual is fit and proper, Scottish Friendly will consider, and be satisfied that, an individual:

- Has the personal characteristics (including being of good repute and integrity);
- Possesses the level of competence, knowledge and experience;
- Has the qualifications; and
- Has undergone or is undergoing all training;

required to enable such person to perform their senior manager function, key function or certification function effectively and in accordance with any relevant regulatory requirements.

In determining whether an individual is fit and proper, Scottish Friendly considers the information contained in the following assessments:

Fitness and Propriety Questionnaire - considers honesty, integrity and reputation and considers whether the individual is financially sound.

Regulatory References (on commencement of employment) - provides information on previous employers' assessment of the individual`s conduct and fitness and propriety.

Employee Screening Check - supplements the self-attestation in the F&P questionnaire and identifies whether the individual has had any CCJ`s/Court Decrees or Bankruptcy, Sequestration or Insolvency arrangements.

Criminal Records Check (on commencement of employment) - supplements the F&P Questionnaire and considers whether the individual has been convicted of a criminal offence.

Competency Assessment - records why the individual is competent and capable to carry out the function.

Conduct Assessment - considers whether the individual`s past conduct has breached the regulator`s conduct rules.

The Chief Executive performs the F&P assessments.

For individuals in the certification regime, a certificate will be issued confirming

- that Scottish Friendly is satisfied that the person is a fit and proper person to perform the Certification Function
- the aspects of the Scottish Friendly`s business in which the individual is involved.

B.3 Risk management system including the Own Risk and Solvency Assessment

Risk Governance

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

The Board have delegated some responsibilities for risk to the Audit Committee of the Board (AC); to assist the Board in reviewing the systems of internal controls and the external financial reports of the business, and to the Risk Committee of the Board (BRC); to provide focused support and advice on risk governance and to assist the Board in reviewing the systems for managing all aspects of the risk universe. On behalf of the Board, the BRC also conducts an annual assessment of the effectiveness of the Risk function.

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 appropriate. Each Executive is required to report on their respective area to the ERC on at least a quarterly basis.

Scottish Friendly operates a 'three lines of defence model' in the management of risk so that there are clearly defined roles and responsibilities within our Risk Management Framework:

- The First Line of Defence is the operational areas across Scottish Friendly which are responsible for the identification and management of day-to-day risks and controls across the business. The management of risks, monitoring of risks and the reporting of breaches of risk appetite are the responsibility of each Executive Risk Owner. In addition, the governance structure includes first line oversight committees. These meetings are chaired by the relevant Executive and membership includes the Risk and Compliance function.
- The Risk Function is part of the Second Line of Defence, led by the Chief Risk Officer (SMF4) and reporting to the Executive Risk Committee and Board Risk Committee. The Risk Function has a clear mandate which is set by the Board and reviewed annually.
- The Chief Risk Officer (SMF16) is accountable for the Compliance Function supported by the Senior

Compliance and Financial Crime Manager.

- The Third Line of Defence is independent assurance of the adequacy and effectiveness of our risk and control environment and this is provided by the Internal Audit Function (provided by EY) which delivers a cyclical and prioritised programme of risk based audits covering all aspects of work undertaken in the First and Second Line business areas over a period of years.

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

Remit of the Risk and Compliance teams

The Risk Function's remit, set out below, defines the scope of activities carried out across Financial and Insurance Risk, Enterprise Risk Management (ERM), including operational risk & resilience, and Regulatory and Conduct Risk:

- **Financial and Insurance Risk**
  - Oversight of financial and insurance risks, including financial risk of climate change
  - Oversight of technical provisions and capital
  - Oversight of with profits (in conjunction with the With Profits Actuary)
  - Determination of methodology for setting stress and scenario testing (SST), reverse stress testing (RST) and Pillar 2 capital
  - Own Risk and Solvency Assessment (ORSA) Pillar 2 capital, includes review of actuarial models
  - Emerging Risk Process
  - Review, challenge and assess compliance with applicable financial and insurance risk policies
  - Risk reporting
  - Deep dive reviews supporting Risk Opinions
  - Oversight of Change Projects
- **ERM (including operational risk & resilience)**
  - Oversight of operational risk (including operational resilience, information security and technology risk), data risk and strategic risk
  - ERM Framework - design and maintain frameworks (e.g. ERM, Policy Framework, Risk Appetite etc.)
  - Lead risk culture embedding and education
  - Risk reporting, including aggregation of Scottish Friendly's Regular Risk Reporting
  - Develop, implement and maintain GRC Risk system
  - Regulatory and external risk reporting – ORSA

- Deep dive reviews supporting Risk Opinions
- Review, challenge and assess compliance with applicable operational risk policies
- Oversight of Change Projects

- **Regulatory and Conduct Risk**
  - Forward looking regulatory risk monitoring
  - Risk and Breach reporting
  - Regulatory reporting
  - Deep dive reviews supporting Risk Opinions
  - Provide advice, guidance and oversight of product manufacture, distribution and financial promotions
  - Review, challenge and assess compliance with applicable conduct and regulatory risk policies
  - Oversight of conduct risk (including partnerships)
  - Oversight of regulatory risk and management of Scottish Friendly's regulatory engagement
  - Oversight of Change Projects

The Compliance Team's remit, set out below, defines the scope of activities carried out across Regulatory and Financial Crime Risk.

- **Policy, Guidance and Business Support**
  - Regulatory horizon scanning to identify key regulatory change topics that will impact Scottish Friendly e.g. PRA, FCA.
  - Production of regulatory change update to the Executive summarising relevant regulatory changes.
  - Updating and issuing regulatory action tracker, providing an update on key items of inflight regulatory change.
  - Assist business projects, including regulatory change initiatives, to interpret PRA/FCA rules and relevance to Scottish Friendly.
  - Submitting SM&CR applications / notifications, in conjunction with HR.
  - Breach and risk event oversight and reporting.
  - Point of contact for the FCA.
  - Coordination of FCA returns.
  - Compliance reporting to Executive, ERC and BRC updates.

- **Compliance Monitoring**
  - Planning and development of risk-based annual monitoring plan.
  - Delivery of annual monitoring plan.
  - Production of compliance monitoring reports, setting out findings and recommendations.
  - Monitoring of actions taken by Scottish Friendly to address any deficiencies in compliance with obligations.
  - Ensuring appropriate systems and controls are in place to

demonstrate compliance by Scottish Friendly with the applicable regulatory requirements.
- Working with business managers to improve control effectiveness and agree any action required.
- Compliance reporting to Executive, ERC and BRC updates.

- **Financial Crime**
  - Design and implement internal anti-money laundering systems and procedures.
  - Review and challenge 1st line AML and Fraud controls.
  - Reviewing suspicious activity reports (SARs) and deciding whether to report to NCA.
  - Provide guidance to the business on how to proceed once a SAR has been made in order to guard against risks of tipping off or prejudicing an investigation.
  - Liaise with NCA or relevant law enforcement agencies on issues or transactions reported.
  - Annual monitoring of Scottish Friendly's PEPs/RCAs/SIPs.
  - Contact point for restraint orders / court orders / Social Security Fraud Act 2001.
  - Maintain and update relevant Financial Crime Policies e.g. Anti-Bribery & Corruption Policy.
  - Submitting the FCA's annual Financial Crime Return.
  - Production of annual Money Laundering Reporting Officer report to the Board.
  - Financial Crime risk reporting to Executive, ERC and BRC updates.

The Risk Management Framework

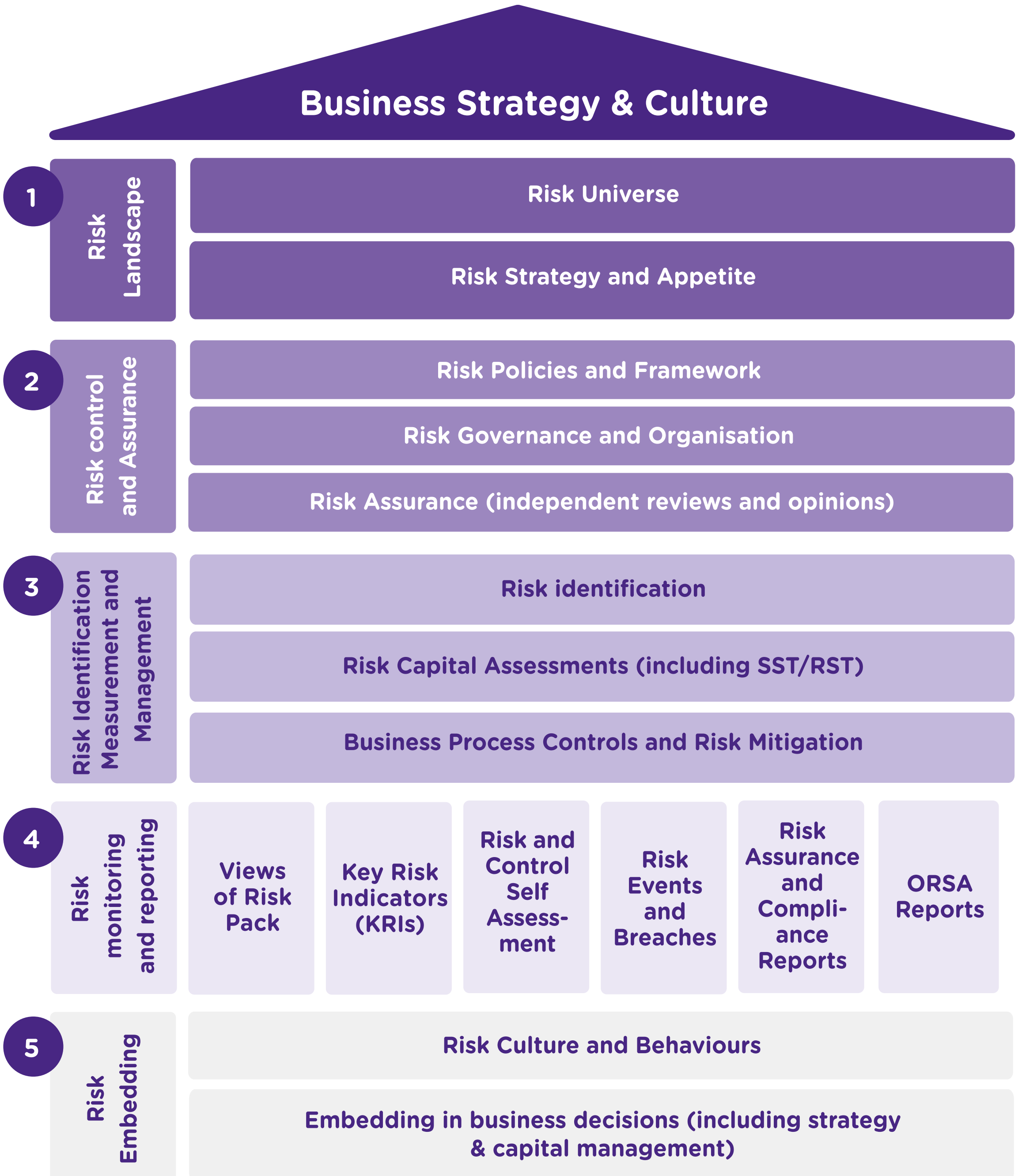
Scottish Friendly maintains a robust Risk Management Framework (RMF) that creates an effective risk management capability across the business. The RMF describes both the strategic aspects of risk management, such as stress testing, as well as the more operational aspects such as risk assessment and assurance.

The five key components of the RMF are:

1. Risk Landscape: sets out the wide range of risks to which SFA is exposed, the risk strategy and appetite of the Board and associated risk triggers and tolerance levels.
2. Risk Control and Assurance: sets out the risk policies and frameworks that provide the mechanism which sets out how the identification, measurement and management of risk against appetite will operate. It sets out the organisation and governance structure which is in place to provide assurance to the Board, our members and other stakeholders that risks are being appropriately managed.
3. Risk Identification, Measurement and Management: sets out how

current and emerging risks are identified, the forward looking assessment of the impact on the capital required to meet

the risks to achieving strategy and business objectives, and the mechanism by which the business mitigates or manages



the risks inherent in business processes.

4. Risk Monitoring and Reporting: a regular cycle of risk reporting through appropriate governance structures to inform decision making, monitoring and pro-active action.
5. Risk Embedding: a strong firm-wide risk culture is a key element of effective risk management. SFA aims to deliver a culture of risk awareness through desired behaviours, key business decisions, day-to-day operations and change management.

The value of risk management for the benefit of Scottish Friendly's members and business 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 2nd line at key points in the decision making process.
- The business embed risk management in the day-to-day business processes through operation of effective controls. In addition, there is a process to assess business compliance with the risk policies which is reported to the Risk Committees.
- Embedding risk management in the management of change within our business.
- Embedding of risk supports enhancement of business performance and capital management to the benefit of our policyholders and delivery of SFA's strategy.

ORSA

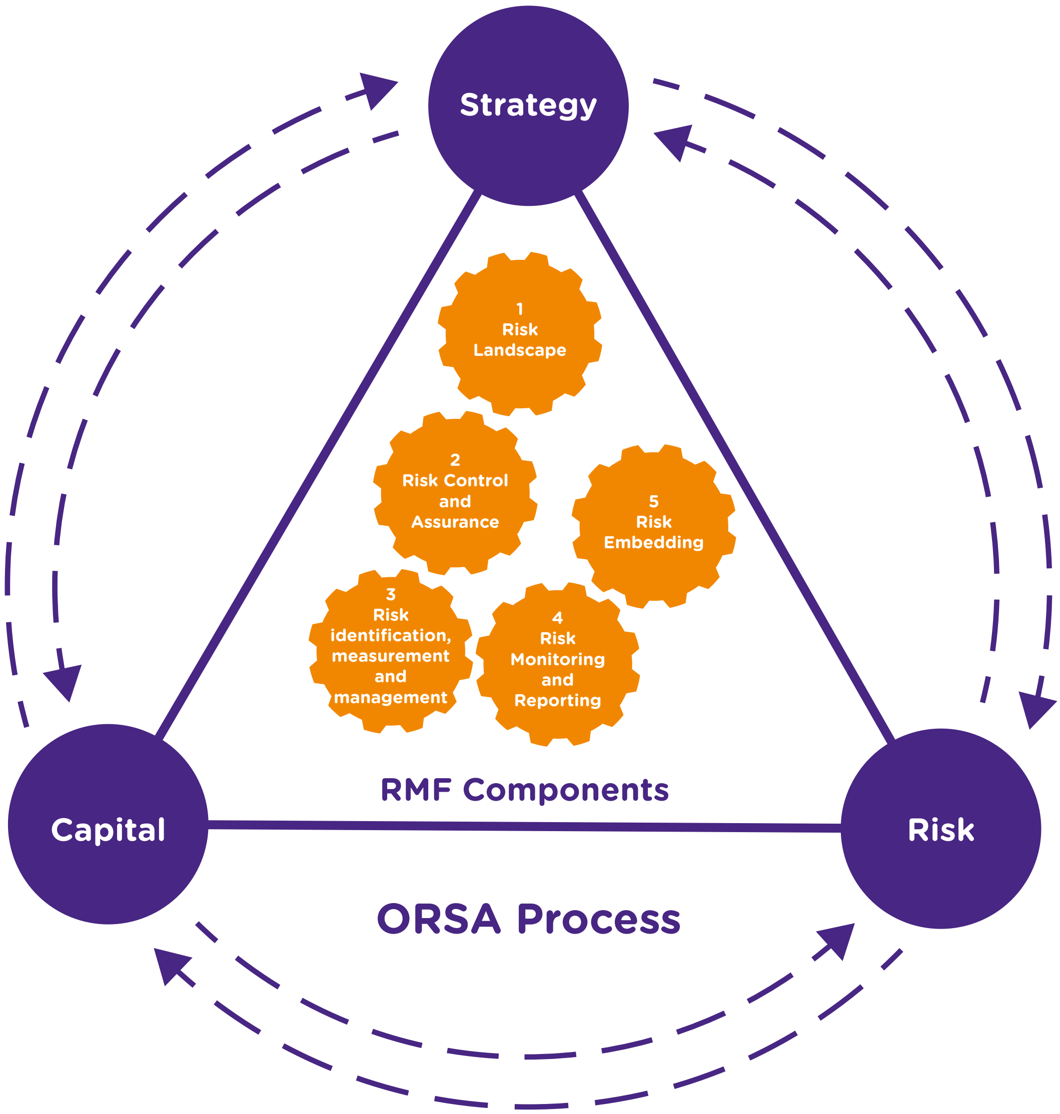
The ORSA is a key process used in the identification, management and mitigation of risk. Each component of the risk management framework feeds into the ORSA, in order to enable an integrated approach towards risk management throughout Scottish Friendly.

The ORSA process is a dynamic process which links:

- Business strategy to the risks SFA takes and manages;
- the risks managed to the capital held against those risks; and
- the capital held to the strategy (for example, as either a potential enabler or constraint on writing new business and continued merger and acquisition activity).

The purpose of the ORSA is to:

- understand and manage Scottish Friendly's risks and associated controls;
- assess the risk profile against risk appetite;
- review forward looking assessment of future solvency, based on the business and strategic plans, which takes into account both the current risk profile and the risk profile following acquisitions;
- carry out stress and scenario testing (including reverse stress testing) to understand the impact of changes to the risk profile; and
- allow the Executive team and Board to make informed strategic decisions that impact the firm's risk profile.



In particular, the ORSA considers the extent to which level and type of capital may be appropriate for risks identified over Scottish Friendly's five-year business planning period. To this end the ORSA process involves a forward-looking assessment of capital requirements and capital resources over a five year period based on Scottish Friendly's risk profile and strategic plans. Within this projection the ORSA considers whether the level of capital coverage is compliant with Scottish Friendly's solvency risk appetite statements as well as the associated limits / triggers.

The 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. The ORSA is completed alongside, and is consistent with, the business planning process.

Responsibility for co-ordination of the ORSA process, and ownership of the ORSA policy, resides with the Chief Risk Officer. The key output of the ORSA process is an annual ORSA report which is reviewed by senior management and approved by the Board. An ORSA report is also produced following a significant change to the risk profile of the business. The Board approved ORSA Report is sent to the PRA.

Internal Control System

Each Function within the business is required to identify, in accordance with the risk management framework and risk policies, the risks arising from the specific activities undertaken within the function and to design and operate a suite of key controls which mitigate those risks.

For the purposes of assessing risk and the performance of key controls, Scottish Friendly maintains a suite of Risk Registers. The risk registers document the risk definition, inherent and residual risk ratings, effectiveness of design and operation of key controls and Executive Risk Owners.

Functional Risk Registers are in place to record and report on operational risks and controls across key processes within each business area. On a quarterly basis, the Executive Risk Owners for each functional area are required to submit their self-assessments of control effectiveness to the second line. The output of this process enables Executive Risk Owners at functional area level to confirm to their assessment of residual risk.

The output of the functional risk assessment is incorporated in the Corporate Risk Register ('CRR'). The CRR records and reports the inherent and residual risk to the business as a whole per risk category i.e. the CRR provides a 'total' view of the risk exposure across Scottish Friendly. The CRR is informed by underlying functional risk assessments, key risk indicators, risk events and breaches and other sources of information. It also incorporates a forward looking view as well as a current point in time of risk exposure.

The Risk Committee is responsible for overseeing the process as well as the output of the process. Each Executive Risk Owner is responsible for ensuring that the control self-assessment is completed within the timeframe set by the Risk Function, as well as ensuring that evidence of testing is collated to support the confirmation that key controls are fit for purpose and that they are operating as intended. Where a failure is identified, action is required, and the Risk Function will track progress of remediation. On a quarterly basis, or more frequently, the Compliance function in conjunction with the Risk Function, reviews and challenges the assessments made by the Executive Risk Owners.

B.4 Internal Audit System

The following provides more information about Scottish Friendly's Internal Audit Function:

The Internal Audit Function (IAF) has the objective of providing management and the AC with an independent assessment of the effectiveness of internal control systems in the areas outlined and agreed in the Internal Audit Plan.

The Internal Audit Plan is prepared annually and approved by the AC. All IAF reports are presented to the AC.

Fundamental Principles Under Solvency II

SFA incorporates the IAF and associated reporting lines into the organisational structure in a way that ensures that the IAF is free from influences that may compromise the IAF's ability to undertake its duties in an objective, fair and independent manner. The persons carrying out the IAF shall not assume any responsibility for any other function.

The IAF operates under the ultimate responsibility of, and reports to the AC and, where appropriate, cooperates with other functions in carrying out their roles.

The persons carrying out the IAF will have the necessary authority, resources and expertise to carry out their responsibilities. They will also have unrestricted access to all relevant information necessary to carry out their responsibilities. The persons performing the IAF will promptly report any major problem in their area of responsibility to the AC or Board.

The IAF shall:

- establish, implement and maintain an audit plan setting out the audit work to be undertaken, taking into account all activities and the complete system of governance of Scottish Friendly;
- take a risk-based approach in deciding its priorities;
- report the audit plan to the AC;
- issue recommendations based on the work carried out and submit a written report on its findings and recommendations;
- verify compliance with the decisions taken by the AC on the basis of those recommendations.

Where necessary, the IAF may carry out audits which are not included in the audit plan.

Relationship with Management/Other Stakeholders

IAF has a dual reporting role to Management for assistance and support in organising and conducting assignments, and to the AC for strategic direction and accountability. IAF will take account of the activities of external audit and external audit will review the planned activities of the function to assess the scope and relevance of the work to the external audit activity. This will facilitate a “joined up” approach where it is appropriate to do so.

Internal Audit cannot absolve management of responsibility for internal controls and must ensure it is not involved in the operation of controls.

IAF Process

Internal Audit will produce a proposed schedule of audits to be performed during the year, to be submitted to the AC for approval.

At the conclusion of each element of the Internal Audit Plan a draft report will be prepared. Auditees will be required to consider their element of the report for factual accuracy and to provide management responses for considering the recommendations, and where applicable, realistic target dates for implementation. Final reports will then be issued to auditees, the Executive Team and the AC.

B.5 Actuarial Function

Scottish Friendly's actuarial function has the following responsibilities:

- To fulfil the Chief Actuary SMF20 role, responsible for taking all reasonable steps to ensure the continued solvency, safety and soundness of Scottish Friendly, including actuarial investigations and regular valuations on the Solvency II and ORSA reporting bases;
- Undertaking the capital calculations, and ensuring adequate provisions are available to meet policyholder benefits in all reasonably foreseeable circumstances in accordance with the risk appetite and taking due account of liquidity;
- Ensuring regulatory and legislative requirements are met, including annual review of the operation of the Principles and Practices of Financial Management (PPFM);
- Undertaking regular and ad hoc exercises including bonus investigations, calculations, reviews, analyses, profitability and experience monitoring, reinsurance arrangements, reports and regulatory submissions as required from time to time;
- Assisting in the Product Development processes. For example review of: product design, profit testing, specification and appropriate reinsurance arrangements; and
- Specifying and implementing claims calculations bases and methods including monitoring and application of Market Value Adjustments (MVAs) as and when required.

B.6 Outsourcing

Outsourcer Failure risk is defined as failure of outsourcing or supplier arrangements and failures within the administration undertaken by partners, including breach of contract.

Scottish Friendly seeks to manage its exposure to Outsourcer Failure risk by establishing minimum policy requirements set out in the Outsourcing and Key Supplier Policy and supporting practices/procedures that align with the agreed requirements. The Outsourcing Committee provides oversight controls to monitor the delivery of the services provided by outsourcers, suppliers and partners and ensures that appropriate action is taken to address any issues identified.

As at 31 December 2022, the following key co-sourced / outsourced functions are considered critical or important in line with the terms of 7.2 of Conditions Governing Business in the PRA Rulebook for Solvency II Firms:

- Internal Audit (EY) (co-sourced arrangement)
- With Profits Actuary (Hymans Robertson, Stephen Makin SMF20a) (outsourced arrangement)

In addition, there are also a number of other material outsourcers recorded on the Outsourcer Register:

- Six contracts which involve an element of policy administration or related servicing activities (Aegon, BGL Group, Neilson Financial Services, Nucleus and Guardian Financial Services, iCOM)
- Six arrangements which cover investment management and related activities such as unit pricing, investment administration or asset management (Icon, Bank of New York, Canada Life, JP Morgan, abrdn plc and Mobius).
- Three other arrangements which relate to the provision of IT services (DSP, Pulsant and FMP Global)

All of these outsourcers are located within the United Kingdom.

B.7 Other Information

There is no other material information to disclose in this situation.

C
Risk Profile

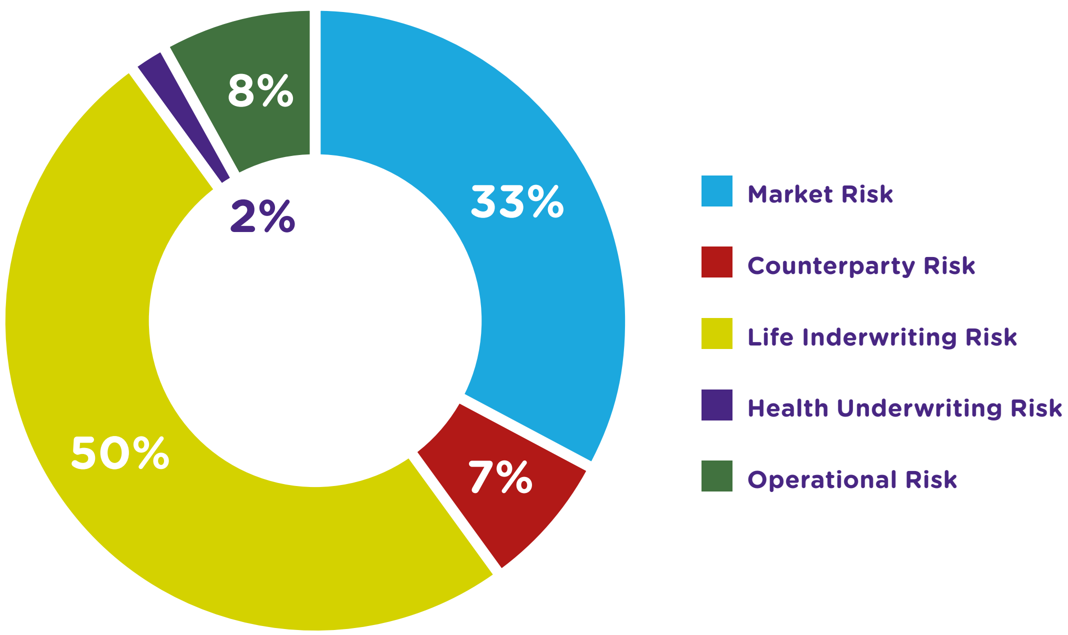
The key risks facing Scottish Friendly are considered within the ORSA and presented to the Board on at least an annual basis.

Quarterly Risk Dashboard reports are presented to the Executive Risk Committee, Risk Committee and Board to highlight any significant movements in the risk profile of the business or the forward-looking risks.

The principal risks to which Scottish Friendly is exposed are underwriting, market, counterparty credit, and operational risks. Within underwriting risk, the principal exposure is to life underwriting risk, as well as a relatively small exposure to health underwriting risk. The RMF supports the identification, measurement, management, monitoring and reporting of these risks.

The figure below shows the split of the main risks to which Scottish Friendly is exposed. The capital requirements shown are based on the Standard Formula capital requirement for each risk:

Note that in the sub-sections below the capital requirements for the Manulife sub-fund are shown as nil. This is because the sub-fund distribution approach is that any losses would be directly reflected in lower payouts, with the strength of the sub-fund sufficient to absorb the prescribed Standard Formula stresses.



C.1 Market Risk

Market risk is the risk of adverse financial impact due to changes in fair values or future cash flows from fluctuations in interest rates, foreign currency exchange rates, equity prices and property values.

As at 31 December 2022 the total capital required in respect of market risk facing the business was £41.1m (2021: £60.4m). This has reduced materially over the year, primarily as a result of management activity taken to sell some of the excess equities previously held within working capital and thereby ensure a closer match between the economic exposure of the assets and liabilities. There was also a fall in the equity symmetric adjustment over 2022.

The total market risk capital is comprised of the following risks across each of the sub funds:

Business Block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Manulife £m	Aggregate £m
Interest rate risk	7.8	0.0	0.0	0.5	8.3	0.0	**16.6**
Equity risk	22.7	0.2	0.0	0.0	7.2	0.0	**30.1**
Property risk	3.3	0.0	0.0	0.0	0.7	0.0	**4.0**
Spread risk	2.2	0.0	0.0	0.3	1.0	0.0	**3.5**
Currency risk	0.0	0.0	0.0	0.6	0.0	0.0	**0.6**
Other market risk	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Diversification	(7.9)	(0.0)	(0.0)	(0.4)	(5.4)	0.0	**(13.7)**
Total market risk	**28.1**	**0.2**	**0.0**	**1.0**	**11.8**	**0.0**	**41.1**

The primary driver of market risk is "equity risk". This risk arises from the equities held to back with-profits asset shares, whereby a fall in equity values results in an increase in the cost of guarantees. In addition, equity risk arises as a result of holdings of equity within the unit-linked funds, including those transferred from Canada Life. Falls in equity values reduce the value of these funds, resulting in a corresponding reduction in the expected future income stream for Scottish Friendly.

Further quantitative analysis on the composition of Scottish Friendly's investment portfolio can be found within Note 14 – Note 18 inclusive of the 2022 Annual Report and Accounts.

In addition, further quantitative analysis on the credit quality of Scottish Friendly's investments can be found within the "Credit Risk" section of Note 35 of the 2022 Annual Report and Accounts.

Risk Concentrations

Scottish Friendly avoid concentrations of market risk through the design of its investment strategy. Scottish Friendly primarily invests in a range of OEICs and other similar collective investment vehicles which maintain a balanced and diversified investment strategy and avoid material exposures to single names. The Investment Function also undertakes analysis at an appropriate frequency to consider the aggregate exposure across all of Scottish Friendly's investments and ensure that there are no material single name exposures which are outside of risk appetite. The largest single name exposure is to the UK Government through holdings in gilts.

Risk Mitigation

Market risk is mitigated through the selection of assets to closely match key characteristics - such as duration and currency - of Scottish Friendly's liabilities. Scottish Friendly also maintains a portfolio of derivatives, primarily swaptions and exchange traded futures and forward contracts, which are held to mitigate exposure to interest rate risk and currency risk which arises from certain liabilities or features of investment strategy.

Scottish Friendly's non-linked asset portfolio is managed on a day-to-day basis by external specialists within JP Morgan and abrdn. These managers are permitted to make short-term tactical decisions, within pre-defined upper and lower bounds, to actively manage and mitigate market risks as the external environment develops. The Investment Function and Investment Committee provide close oversight over these external managers, with formal reporting to the Investment Committee on a quarterly basis.

C.2 Underwriting Risk

Underwriting risk is the risk of potential losses arising from inaccurate assessment of the risks entailed in writing an insurance policy. This is mitigated by the provision of reinsurance arrangements, limits on cover and explicit exclusions.

Under the Solvency II regulations, underwriting risk is calculated separately for life insurance business and health insurance business. As a result of the transfer from Canada Life, Scottish Friendly also has a small portfolio of health insurance business.

As at 31 December 2022 the total capital required in respect of the life underwriting risk exposure was £61.2m (2021: £73.8m). This is comprised of the following risks across each of the sub funds:

Business Block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Manulife £m	Aggregate £m
Mortality	12.5	0.0	0.0	0.1	0.0	0.0	**12.6**
Longevity	3.3	0.0	0.0	0.1	4.7	0.0	**8.1**
Disability	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Lapse	36.1	0.2	0.0	0.1	5.9	0.0	**42.3**
Expense	17.9	0.0	0.0	0.1	1.5	0.0	**19.5**
Revision	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Catastrophe risk	1.1	0.0	0.0	0.0	0.0	0.0	**1.1**
Diversification	(19.3)	(0.0)	(0.0)	(0.2)	(2.9)	0.0	**(22.4)**
Total life underwriting risk	**51.6**	**0.2**	**0.0**	**0.2**	**9.2**	**0.0**	**61.2**

The corresponding exposure to health underwriting risk was £2.2m (2021: £2.9m), split as set out in the following table:

Business Block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Manulife £m	Aggregate £m
Health Mortality	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Health Longevity	0.1	0.0	0.0	0.0	0.0	0.0	**0.1**
Health Disability	2.0	0.0	0.0	0.0	0.0	0.0	**2.0**
Health Expense	0.2	0.0	0.0	0.0	0.0	0.0	**0.2**
Health Revision	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
Health Lapse	0.3	0.0	0.0	0.0	0.0	0.0	**0.3**
Diversification	(0.4)	0.0	0.0	0.0	0.0	0.0	**(0.4)**
Total health underwriting risk	**2.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**2.2**

The level of underwriting risk has reduced significantly from 2021. This is primarily due to increases in interest rates over 2022, which results in greater discounting being applied to liabilities and consequently a lower change in the liability under a 1 in 200 stress. Lapse risk remains the most significant exposure. Scottish Friendly's lapse capital is based on its exposure to a "mass lapse" event, under which there is a sudden and significant exit of business that is expected to be profitable in the future.

Risk Concentrations

Scottish Friendly's diverse back-book of insurance contracts avoids any material concentrations arising in respect of underwriting risk – in particular, this offers Scottish Friendly diversification across product type, geography, age and gender.

Scottish Friendly also makes extensive use of reinsurance – both in respect of the back-book and in respect of new business - to avoid concentration exposure to very large policies, and to avoid creating an exposure to a single product line.

Scottish Friendly does actively sell a number of products which give rise to lapse risk. This is the most material underwriting risk. Whilst this risk is not concentrated on a single line of business or single target market, it has been identified that certain external events, such as a deep and prolonged recession in the UK, could cause this risk to crystallise concurrently across multiple lines of business. This is considered as part of the annual ORSA assessment and capital is held to ensure that Scottish Friendly is able to withstand a very extreme mass lapse event occurring.

Risk Mitigation

Underwriting risk arising from selling new business is primarily mitigated in accordance with the insurance risk management policy, and, more generally, the product design / new business sales processes, which are specifically designed to identify and mitigate any underwriting risks which are outside of Scottish Friendly's risk appetite.

Scottish Friendly also makes extensive use of reinsurance – both for new business and in respect of the legacy back-book - to cede underwriting risks to third party reinsurers. This allows acts as a mitigant to the concentration risk which could otherwise arise from very large claims on the protection book.

There are risks which, by the nature of operating insurance business, cannot be fully mitigated. The Actuarial and Commercial Functions undertake regular close monitoring of emerging experience which would allow corrective action to be taken if it became clear that experience was emerging in a manner which is not consistent with Scottish Friendly's expectations.

The business strategy also offers a mitigant against underwriting risk, by ensuring diversification is achieved across product lines and target markets.

C.3 Counterparty Default Risk

Counterparty default risk is the risk of financial loss as a result of the default or failure of third parties to meet their obligations.

As at 31 December 2022, the total capital required in respect of counterparty risk facing the business was £8.8m (2021: £12.6m). This reduction is primarily due to the increase in interest rates observed over 2022, which results greater discounting of liabilities and consequently a lower value being placed on the amount expected to be recovered from reinsurers. There has also been a reduction in the level of cash held within operational bank accounts as a result of management activity over 2022 to enhance liquidity management processes.

This is comprised of the following risks across each of the sub funds:

Business Block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Manulife £m	Aggregate £m
Type 1	6.5	0.0	0.0	0.0	1.0	0.0	**7.5**
Type 2	1.7	0.0	0.0	0.0	0.0	0.0	**1.7**
Diversification	(0.4)	0.0	0.0	0.0	0.0	0.0	**(0.4)**
Total counterparty risk	**7.8**	**0.0**	**0.0**	**0.0**	**1.0**	**0.0**	**8.8**

Note:

- Type 1 details the exposures to other insurance companies (through reinsurance arrangements) and to banks.
- Type 2 details all remaining exposures.

The primary driver of counterparty default risk refers to the risks that reinsurers or banks are unable to satisfy their obligations and cause financial loss. Only high-quality counterparties are sought as counterparties, collateral arrangements are put in place where appropriate and concentration risk is managed by using a number of banks and reinsurers to spread the risks.

Risk Concentrations

Scottish Friendly's counterparty risk appetite places an upper limit on the level of counterparty risk exposure which is permitted from a single counterparty. This applies to reinsurers, banks, third-parties to derivative contracts and debtors. The position against risk appetite is monitored by the Technical Review

Committee on a monthly basis, which would allow corrective to be taken if it was identified to be likely that a counterparty exposure would may breach the risk appetite trigger level.

The most material counterparty risk concentrations arise from Scottish Friendly's reinsurers, to whom underwriting risk has been ceded in the past as well in respect of new business. These concentrations are closely monitored and scenario testing is conducted as part of the annual ORSA assessment to assess the sensitivity of the capital position to key counterparties, both now and in the future as a result of writing new business. This is in turn used to inform business strategy and guide the selection of new counterparties if necessary.

Risk Mitigation

Counterparty risk is primarily mitigated through ensuring compliance with Scottish Friendly's risk appetite statements as well as the counterparty risk management policy. In particular, this requires all material counterparties to have a minimum credit rating and also limits the maximum exposure permitted to any single name.

The Finance Function monitor the counterparty exposures and provide a monthly credit report to the Technical Review Committee which highlights the position against risk appetite and would permit timely action to be taken if a counterparty's credit quality was deteriorating.

In addition, a number of counterparty exposures are also mitigated by the third-party providing collateral to Scottish Friendly – either by posting assets into a custody account, or by way of granting a legal charge to Scottish Friendly over the third-party's balance sheet.

C.4 Liquidity Risk

Liquidity risk is the risk that loss or adverse circumstances will result in the inability of Scottish Friendly to meet its liabilities when they fall due.

Liquidity risk is subject to extensive management oversight and reporting. Analysis of projected cash inflows and outflows is performed by Finance with input from Actuarial on a monthly basis, and the projected liquidity position is monitored through regular risk reporting. Liquidity requirements are considered over one -month and three -month time horizons.

Consideration is also given to longer term liquidity risks as part of the ORSA. As part of the assessment within the ORSA, a specific stress scenario considers the potential liquidity strain which could arise from having to post collateral in respect of Scottish Friendly's derivative positions under a severe market risk event. This analysis is also considered by the Board when determining the level of liquid resources which Scottish Friendly must hold in order to remain within its liquidity risk appetite.

Reinsurance claims payments and schedules are subject to regular monitoring and any issues raised at regular relationship management meetings. The Investment Committee provides oversight of the asset allocation and ultimately maintains a strategy that includes a proportion of the portfolio that is very liquid e.g. listed equities, gilts, which if required, could be sold to provide additional liquidity during stressed periods.

Given the nature of this risk and the controls in place, Scottish Friendly did not hold any capital against this risk as at 31 December 2022.

Further quantitative analysis on the maturity profile of Scottish Friendly's liabilities can be found within the "Liquidity Risk" section in Note 35 of the 2022 Annual Report and Accounts.

The level of expected profits in future premiums ('EPIFP') is disclosed within the QRTs. This is calculated on a net of reinsurance basis for non-profit business, based on grouping together similar product lines. This is considered the most appropriate measure of the level of future profits which are anticipated in the future to the benefit of Scottish Friendly.

C.5 Operational Risk

Operational risk is the risk of loss or adverse consequences for the business resulting from inadequate or failed internal processes, people or systems, cyber risk, or from external events.

The operational risk capital requirement is calculated in line with the prescribed Standard Formula basis, with the results shown below. The capital requirement is calculated based on the earned premiums, the technical provisions, and the expenses on unit linked business.

As at 31 December 2022 the total capital required in respect of operational risk facing the business was £9.7m (2021: £11.1m). The operational risk in respect of the Manulife fund is held in the SF Main Fund. Operational risk is comprised of the following capital requirements across each of the sub funds:

Business Block	SF main fund £m	LANMAS £m	Rational Shelley £m	Scottish Legal £m	M&GM £m	Manulife £m	Aggregate £m
Total operational risk	8.8	0.1	0.0	0.2	2.9	0.0	**9.7**

The level of operational risk capital is substantially unchanged from that in 2021.

Risk Mitigation

The nature of operational risk means that it is most effectively mitigated through effective first line of defence controls within procedures and, where appropriate, automated processes to minimise the risk of human error. The internal control system which is operated by Scottish Friendly to mitigate operational risk is described within section B3.

In addition, Scottish Friendly also has insurance policies which further mitigate against certain operational risks which are not otherwise well mitigated through a robust control environment.

In addition to the Standard Formula operational risk capital requirements, Scottish Friendly also monitors operational risk using bespoke stress and scenario modelling within the ORSA, calibrated using inputs from Scottish Friendly's Executive management team.

C.6 Risk Sensitivities

Scottish Friendly conducts a number of stress tests to assess the implications of various scenarios on the capital position of the business. These are performed as part of the ORSA process which is completed at the same time as the Business Planning and, longer-term, Strategic Planning processes.

The following stress scenarios were defined and developed following input from both the Executive and Board. These were tested quantitatively within the ORSA:

- Combined economic and demographic scenario
- High inflation tamed by significant increase in interest rates causing prolonged recession
- High inflation allowed to prevail by adopting expansionary monetary policy to grow the economy
- High profile operational failure scenario
- Demographic misestimation
- Counterparty downgrade
- Efficiency and change projects overrun
- Emerging risk – charge cap
- Liquidity scenario
- Climate change scenario

The scenarios consider the immediate impact to the capital position e.g. payment of remediation and costs, as well as the longer-term impact on revenues e.g. impacting ongoing sales volumes. The exercise concluded that Scottish Friendly remains well capitalised under an appropriate range of adverse scenarios - in particular, in all the scenarios considered Scottish Friendly was comfortably able to meet its solvency capital requirement and maintain a solvency coverage ratio well in excess of 100% without deploying any additional management actions.

Additional management actions, beyond those modelled in the SCR calculation, have not been incorporated in the scenario assessment, as the solvency position does not necessitate the use of the actions to maintain solvency. In reality, such actions would be taken if the solvency of Scottish Friendly was under threat.

In addition to the quantitative analysis detailed above, a number of further scenarios were also considered qualitatively within the ORSA, in order to assess the controls and other risk mitigants in place within the business, and to highlight any areas where further action is required. These scenarios include high inflation becoming longer-term, an operational resilience failure scenario, a partner / outsourcer failure scenario and a small number of emerging risk scenarios. Finally, reverse stress tests were also completed by the business based on input from the Executive and the Board.

Further quantitative analysis which demonstrates the sensitivity of the capital position to insurance and market risks can be found within Note 35 of the 2022 Annual Report and Accounts.

C.7 Other Risks

The ORSA considers the “emerging risks” to which Scottish Friendly is exposed. Emerging risks are new or changing risks that can have a serious impact on the business environment or broader society. These risks are known to some degree, but may not materialise or have an impact for several years.

Scottish Friendly recognises and incorporates emerging risks in strategic planning, as they typically relate to the long-term time horizon. By monitoring trends that are beginning to emerge, Scottish Friendly can identify potential opportunities as well as risks, and develop or modify strategies to either minimise the negative effects or capitalise on the potential opportunities that an emerging risk may present. These emerging risks inform the choice of stress scenarios considered in the ORSA. No capital is specifically held against emerging risks.

D
Valuation for Solvency Purposes

Valuation Basis

The Solvency II regulations require Scottish Friendly's assets and liabilities to be measured in accordance with the principles of an arm's length transaction between knowledgeable willing parties using market consistent valuation methods. In the case of assets, this is described as "fair value".

The differences between the Statutory Accounts and Solvency II balance sheets as at 31 December 2022 are shown below. As the Statutory Accounts are principally valued at fair value, the differences between the Solvency II balance sheet and the Statutory Accounts are limited in nature.

The key differences as at 31 December 2022 are:

- In the Statutory Accounts the financial liability for investment contracts is valued based on the carrying value of the assets and liabilities that are held to back the contract, plus an additional amount equal to the present value of excess future policy costs over future charges. On a Solvency II basis these contracts are valued equal to the expected future cash flows (including allowing the recognition of future charges where they are projected to exceed future expenses) plus a risk margin. This gives rise to a valuation difference of £3.3m.
- Certain cash assets held in respect of unit-linked contracts of insurance (£8.2m) are recognised as cash on the Statutory Accounts basis and as investments on the Solvency II balance sheet.
- A £41.4m negative goodwill liability is recognised on the Statutory Accounts balance sheet. This recognises that the price paid for the acquisition of business from Canada Life Limited and Mobius Life Limited was less than the fair value of the net assets acquired. This amount is amortised over time as the capital requirements run-off and expected profits from this book emerge. Intangible assets such as goodwill are not recognised on the Solvency II balance sheet in accordance with Solvency II regulations.
- The pension scheme surplus is restricted on a Solvency II basis to be in line with the contribution of the pension scheme to the capital requirements. There is no such restriction in the Statutory Accounts. This results in a valuation difference of £21.8m. The related tax charge of £8.9m, recognised as part of the "other" liabilities within the Statutory Accounts, is not recognised on the Solvency II Balance sheet, as the impact is already reflected in the surplus restriction.
- There is a unit-linked reinsurance agreement in place with Mobius Life. Within the Statutory Accounts the underlying investments held by the Mobius policyholders are recognised directly, whereas on the Solvency II balance sheet this is recognised as a reinsurance asset. This results in a large switch, £272m, from investment assets to reinsurance assets. This is entirely

presentational and there is no impact on the net position.

- An aggregate deferred tax asset is shown in the statutory accounts, but for Solvency II reporting this deferred tax asset is notionally split between the sub-funds. As some of the sub-funds are in a notional deferred tax liability position this results in a switch of c£0.6m between "other assets" and "other liabilities", with no change in the aggregate net position.

The differences between the Statutory Accounts and Solvency II Balance Sheet are shown below.

	Statutory Accounts £000	Adjustments £000	Solvency II Balance Sheet £000
Property & Equipment	3,909	-	3,909
Investments	3,408,422	(264,572)	3,143,850
Derivative assets	4,777	-	4,777
Reinsurance	842,743	272,748	1,115,491
Cash	55,601	(8,174)	47,427
Pension scheme surplus	25,444	(21,822)	3,622
Negative Goodwill	(41,415)	41,415	-
Other	57,914	582	58,496
Total Assets	**4,357,395**	**20,176**	**4,377,571**
Technical Provisions	(4,010,542)	(3,284)	(4,013,826)
Derivative liabilities	(2,207)	-	(2,207)
Other	(121,967)	8,321	(113,646)
Total Liabilities	**(4,134,716)**	**5,038**	**(4,129,678)**
Net Assets	**222,679**	**25,214**	**247,893**

D.1 Assets Valuation

Scottish Friendly's Solvency II valuation principles (including the bases, methods and main assumptions) for each asset class are set out below. Unless otherwise stated (i.e. where there are differences to the Statutory Accounts value column) the valuation methods for UK GAAP are consistent with the valuation methods of the Solvency II regulations. Further details on the UK GAAP valuation principles are set out in the Notes to the Annual Accounts in the Scottish Friendly Annual Report and Accounts for the year ended 31 December 2022.

There have been no significant changes to the valuation principles set out below during the year.

Assets carried at fair value in the Solvency II balance sheet are categorised based upon the valuation techniques used, as follows:

- QMP – quoted market price in active markets for the same assets.
- QMPS – quoted market price in active markets for similar assets.
- AVM – alternative valuation methods.

An active market exists where transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis. Some of Scottish Friendly's financial instruments are valued using alternative valuation methods, which utilise a combination of observable and non-observable market inputs (please see section D.5).

Property, plant and equipment

Land and buildings are valued at fair value. This is the same basis as the Statutory Accounts for Solvency II purposes. A formal valuation of 14-16 Blythswood Square, completed by a professional independent valuer, takes place every three years and was last completed for the 31 December 2021 reporting period.

Plant and equipment are valued at their net realisable value. This is considered by management as an appropriate proxy for fair value of these assets.

Investments

Investments including those held to cover linked liabilities are stated at the current market value as described below:

- Shares and other variable-yield securities, units in unit trusts and shares in OEICs are shown in the balance sheet at market value at the balance sheet date.
- Debt securities and other fixed income securities are valued at the current market value at the balance sheet date.
- Investments in Group undertakings (detailed as Participations under Solvency II) are valued using the adjusted equity value in accordance with the requirements of Article

13.1(b) and 13.3 of the Delegated Acts (2015/35/EU).

- Derivatives are shown in the balance sheet at their marked to market value
- Property acquired as part of the acquisition from Canada Life is held in the Private Portfolio Funds, and the underlying properties are revalued annually.

As at 31 December 2022 the following investments were held by Scottish Friendly (values exclude the cash held in respect of unit-linked contracts of insurance):

	QMP £000	QMPS £000	AVM £000	Total £000
Property held for own use	-	-	3,250	3,250
Equities – unlisted	-	-	64	64
Government Bonds	445,472	-	-	445,472
Corporate Bonds	-	59,868	-	59,868
Structured notes	-	-	2,576	2,576
Collective Investments Undertakings	-	-	454,466	454,466
Derivatives assets	-	431	4,346	4,777
Assets held for index-linked and unit-linked contracts	2,499	170	2,166,441	2,169,110
Total financial assets	447,971	60,469	2,631,143	3,139,583
Derivative liabilities		(2,207)		(2,207)

Reinsurance assets

The recoverables from reinsurance contracts relate to annuity business, which is almost entirely reinsured, protection business, of which a large proportion is reinsured, and reinsurance of certain investment funds (including the pension funds which transferred from Mobius Life Limited). The reinsurance arrangements involve a number of different reinsurers. Regular monitoring is carried out to assess the ongoing risk associated with these arrangements.

The reinsurance assets for Solvency II reporting and the Statutory Accounts have been calculated on best estimate basis in line with Solvency II requirements. An allowance is made for expected losses on reinsurance recoverables due to counterparty default.

Reinsurance contracts in respect of investment business which do not transfer risk to the third party are not recognised as a reinsurance asset in the Statutory Accounts. Instead the Statutory Accounts looks through to the underlying assets held by policyholders within ‘assets held for index-linked and unit-linked contracts’.

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. The valuation in the Statutory Accounts basis is materially consistent with a fair value and therefore the valuation is unadjusted in the Solvency II balance sheet.

Other Assets

These include sundry debtors and prepayments and are recorded at amortised cost. This approximates the fair value valuation basis under Solvency II for these assets. The Statutory Accounts also include a negative goodwill asset, which was recognised on the transfer of a block of business from Mobius Life Limited and a further amount recognised as part of the transfer of the Canada Life book. As an intangible asset, this is not recognised on the Solvency II basis.

D.2 Technical Provisions

The Technical Provisions represent the best estimate liability of future policyholders along with a Risk Margin. The Risk Margin is intended to reflect the difference between the amount which must be paid to another insurer to meet the future obligations for a block of policies and the best estimate value of liabilities for the same block of policies.

The key demographic assumptions in the Solvency II calculations (expense, mortality, morbidity and persistency) are based on the experience investigations carried out in late 2022 and presented to the Audit Committee of the Board in December 2022 and January 2023. The process for setting these assumptions includes consideration of the impact of the COVID-19 pandemic on expected future experience, as well as the impact of rising inflation on customers' ability to save. The economic assumptions (e.g. yield curves and volatilities) are based on relevant market data at 31 December 2022.

The key components of the Technical Provisions are the with-profit benefit reserves, the cost of guarantees, non-profit reserves, unit linked reserves and the Risk Margin. The with-profit benefits reserves (i.e. the asset share for with-profits business) may be calculated using a retrospective or prospective approach.

The retrospective approach involves rolling the asset share forward month-on-month allowing for premiums, investment returns, charges and any other relevant factors.

The prospective approach involves discounting the expected payout to policyholders (including allowance for future bonuses) to the valuation date, allowing for future expenses and premiums.

The with-profits benefit reserves at 31 December 2022 are all valued using a retrospective approach except for the Rational Shelley business and the with-profits business held in the Manulife sub-fund, which are valued using a prospective approach.

The with-profits benefit reserves on Rational Shelley policies were originally calculated using a prospective approach because it was not possible to undertake a retrospective valuation as there was no historical asset share information available when the business was acquired. The asset shares are recalibrated once a year to ensure that they remain appropriate.

The with-profits benefit reserves for the Manulife sub-fund policies are set based on the assets available in the sub-fund (after allowance for the non-profit business in that sub-fund), reflecting the expectation that all free assets will be distributed to the Manulife with-profits policies over time.

Scottish Friendly does not use the matching adjustment ('MA') or volatility adjustment ('VA'), nor does it avail of any of the transitional measures set out within Solvency II (including the TMTP), when calculating its technical provisions.

	2022 £000	2021 (restated) £000
Total Best Estimate Liability	**1,558,201**	**2,017,932**
BEL - Health	11,487	15,696
BEL - Life	1,492,281	1,933,814[1]
BEL - Unit-linked and index linked	54,432	68,422
Total Risk Margin	**30,910**	**46,377**
Risk Margin - Health	194	349
Risk Margin - Life	19,942	33,763
Risk Margin - Unit-linked and index linked	10,774	12,265
Technical Provisions calculated as a whole	2,424,715	2,807,045
Technical Provisions	**4,013,826**	**4,871,354**

Restatement

The Technical Provisions as at 31 December 2021 have been restated to correct an error which was identified in the modelling of the decreasing term assurance product. There was an offsetting change in the reinsurance asset of the same magnitude, and consequently this restatement had no impact on Own Funds:

	2021 as previously reported	Restatement	Restated 2021
Technical Provisions - Life	1,943,500	24,078	1,967,577
Reinsurance Asset	1,561,288	24,078	1,585,366
Unrestricted Own Funds	**249,363**	**-**	**249,363**
Ring Fencing Restriction	(85,627)	-	(85,627)
Own Funds	**163,736**	**-**	**163,736**

1 The 2021 value has been restated to correct an error which was identified in 2022 in relation to the actuarial modelling of a decreasing term assurance liability. This is explained below:

D.3 Uncertainties within the Technical Provisions

The basis items with the largest impact on the overall valuation of Technical Provisions are the assumptions surrounding future claim rates and expenses and the future development of the economic markets, including equity markets and the interest rate yield curve. When setting assumptions for the 31 December 2022 valuation, specific consideration was given to the expected impact of COVID-19 on future claims experience and policyholder behaviour.

In addition, consideration was given to the possible impact of rising inflation on future policyholder behaviour, particularly in relation to the ISA products, and a short-term provision has been added to technical provisions to allow for the period of higher lapses and surrenders while inflation remains high.

D.4 Other Liabilities

The other liabilities are analysed below. These are recorded at amortised cost, with the exception of outstanding claims which is measured on a best estimate of the expected cashflows resulting from all outstanding obligations. In each case, the recorded value approximates the fair value valuation basis under Solvency II for these liabilities.

Claims outstanding is measured on a best estimate of the expected cashflows resulting from all outstanding obligations. This is based on observed experience and relies on judgements about how to interpret that experience and how that experience may change in the future. An increase in the experience of making payments to customers by 10% would increase outstanding claims by approximately £1.6m and a decrease in the experience of making payments to customer by 10% would reduce outstanding claims by approximately £1.6m.

The total amount of other liabilities is £122.0m prior to the application of any Solvency II adjustments. The key liabilities within this total are detailed in the table below:

	2022 £000	2021 £000
Deposits from reinsurers	28,961	36,085
Claims outstanding	47,575	48,640
Creditors arising out of Direct Insurance Operations	8,834	7,508
Other Creditors	10,704	11,365
Accruals and Deferred Income	16,988	2,988
Provisions for liabilities	8,905	31,336
Total	**121,967**	**137,922**

D.5 Alternative Valuation Methods

Some of Scottish Friendly's financial instruments are valued using alternative valuation methods, which use a combination of observable and non-observable market inputs. All of the alternative valuation methods described below follow accepted market practice. The methods are consistent with the permitted alternative valuation methods under SII as set out in Article 10(5) - 10(7) of the Solvency II Delegated Regulation.

There have been no significant changes in the recognition, measurement or valuation base used for financial assets and liabilities during the reporting period.

Asset	AVM £000	Alternative Valuation Method	Assumption
Property held for own use	3,250	Royal Institution of Chartered Surveyors ('RICS') Appraisal and valuation methodology.	As per RICS valuation manual and based on professional judgement of independent valuers.
Equities - unlisted	64	Subsidiaries are valued at net asset value. Equity and Venture Capital ('IPEVC') valuation guidelines.	Non-observable market input, primarily net asset value statements.
Structured notes	2,576	Combination of observable and non-observable market inputs including modelling.	The valuation is based on the discounted value of the estimated future cashflows, including a proportion of the shared appreciation on the underlying property assets.
Collective Investments Undertakings	454,466	Prices are obtained from published information representing the value at which units could be redeemed via the investment manager.	None

Asset	AVM £000	Alternative Valuation Method	Assumption
Derivative assets	4,346	Market approach, which uses prices and other relevant information generated by market transactions involving identical or similar assets, liabilities or group of assets and liabilities.	Various assumptions used depending on derivative, including interest rate curve, discount curve and implied volatility.
Assets held for index-linked and unit-linked contracts	2,166,441	Prices are obtained from published information representing the value at which units could be redeemed via the investment manager.	For property assets, as per RICS valuation manual and based on professional judgement of independent valuers.

Collective vestment Undertakings and Assets held for index-linked and unit-linked contracts consists of holdings in open-ended funds.

The fair value of daily priced pooled investment funds is calculated as equal to the observable unit price. This is obtained from published information where available, otherwise the fair values of underlying assets and liabilities held by the fund, divided by the total number of units at the valuation date is used to calculate the unit price. Unit pricing of managed pooled investment funds does not meet the Solvency II criteria for QMP or QMPS categorisation since prices are not listed on a regulated market or multilateral trading facility.

Unlisted equities are valued under the Equity and Venture Capital ('IPEV') valuation guidelines. The valuation of these securities is largely based on inputs that are not based on observable market data, and accordingly these instruments are categorised as AVM. Where appropriate, reference is made to observable market data.

Derivative positions are valued using observable market inputs and are subject to price verification against independent sources which are used to determine plausible alternative valuation ranges.

D.6 Other Material Information

The information presented in section D provides a true and fair view of the valuation for Solvency purposes of Scottish Friendly.

E
Capital Management

E.1 Own Funds

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;
- 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 core strategic objectives as determined by the Board.

The capital position of Scottish Friendly is monitored on a regular basis by the Risk Committee as part of the Risk Management Framework and is also reviewed formally by the Board. Scottish Friendly has not breached the PRA's capital requirements at any point in the current or prior year.

Composition of Own Funds

Scottish Friendly's capital comprises of its Own Funds. As a mutual these comprise 100% of the profits not yet allocated to members. The vast majority of Scottish Friendly's Own Funds are Tier 1 capital, other than in respect of a deferred tax asset of c£12m which arose in 2022 primarily as a result of taxable losses which arose from the portfolio of fixed interest assets held to back liabilities - albeit part of these taxable losses arose in respect of the ring-fenced sub-funds and so are captured within the reconciliation reserve.

The following table provides a breakdown of the components of the Own Funds.

	2022 £000	2021 £000
Own Funds	**159,776**	**163,736**
Tier 1	153,051	163,736
Surplus Funds	247,893	249,363
Reconciliation Reserve	(88,117)	(85,627)
Tier 2	-	-
Tier 3	6,725	-
% Tier 1	96%	100%

The Surplus Funds item represents the excess of the assets over the liabilities in Scottish Friendly and is the surplus that has not yet been distributed to our participating members. The reconciliation reserve reflects the ring-fencing restriction relating to the closed sub-funds, as described below.

Reconciliation to Funds for Future Appropriations shown in the financial statements

There is a difference between the net assets as shown in the financial statements and the Solvency II value excess of assets over liabilities, which is primarily due to the recognition of an intangible negative goodwill on the Statutory Accounts basis but not on the Solvency II basis. This reflected the transfer of business from Canada Life Limited and Mobius Life Limited and, as an intangible asset, is not recognised on a Solvency II basis. In addition, under Solvency II the level of pension scheme surplus is restricted. Finally, within the Statutory Accounts a different valuation approach is used for investment contracts in line with the requirements stated in the relevant accounting standards. As at 31 December 2022, excess assets over liabilities were £222.7m on a Statutory Accounts basis and £247.9m on a Solvency II basis (before ring-fencing).

Change in Own Funds

The following table shows the change in Scottish Friendly's Own Funds from 31 December 2021 to 31 December 2022.

	2022 £000
Opening Own Funds (as presented in 2021 SFCR)	**163,736**
Increase/(Decrease) in Total Assets	(397,250)
(Increase)/Decrease in Technical Provisions	387,653
(Increase)/Decrease in Current Liabilities	8,127
Total	**162,265**
(Decrease)/Increase in ring-fencing of available capital	(2,490)
Closing Own Funds	**159,776**

The assets and liabilities in the table above are shown net of reinsurance.

Ring Fenced Funds

The Solvency II excess of assets over liabilities is reduced to reflect the impact of ring fencing of individual sub funds. The sub funds are closed to new business and they have separate equity backing mixes resulting in different investment experiences and bonus policies. The excess assets over liabilities in the sub fund are not treated as transferable.

The impact of this on the Own Funds position is shown below. These sub funds are the Rational Shelley sub fund, LANMAS sub fund, the Scottish Legal Life sub fund, the M&GM sub fund and the Manulife sub fund.

	2022 £000	2021 £000
Excess assets over liabilities	**247,893**	249,363
Adjustment for restrictions due to ring fencing	**(88,117)**	(85,627)
Own Funds	**159,776**	163,736

E.2 Solvency Capital Requirement and Minimum Capital Requirement

Scottish Friendly uses the Standard Formula as the basis for calculating capital requirements, having reviewed and assessed the Standard Formula as appropriate for the firm. Scottish Friendly complies in all material respects with the requirements of the PRA rules and Solvency II Regulations related to the SCR and MCR.

The capital position of the business is estimated on at least a monthly basis, with the results communicated to the Board. A full calculation is carried out at least quarterly. The Risk Committee reviews solvency by risk indicators and the financial markets are monitored with the implications on solvency considered if volatility triggers are breached.

The Own Funds are summarised below with more detail provided in the Appendices which contain the relevant Quantitative Reporting Templates.

	2022 Solvency II £000	2021 Solvency II £000 (as reported)
Own Funds	159,776	163,736
Minimum Capital Requirement	35,197	42,348
Solvency Capital Requirement	78,216	94,106
Solvency Ratio	204.3%	174.0%

The solvency coverage ratio has increased relative to the 31 December 2021 position, primarily as a result of the decrease in the SCR, albeit this is partly offset by a decrease in Own Funds due to the increase in interest rates observed throughout 2022. This results in higher projected future charges, greater discounting of liabilities and a consequential fall in the risk margin and SCR. There is also an increase in own funds in respect of a deferred tax asset arising from losses incurred in 2022.

Solvency Capital Requirement split by risk modules

The table below shows the risk modules that make up Scottish Friendly Assurance Society Limited's SCR at 31 December 2022.

	2022 £000	2021 £000 (as reported)
Market Risk	41,072	60,355
Counterparty Default Risk	8,817	12,602
Life Underwriting	61,228	73,791
Health Underwriting	2,162	2,918
Undiversified BSCR	**113,279**	**149,666**
Diversification Credit	(27,566)	(37,678)
Basic SCR	**85,713**	**111,988**
Operational Risk	9,689	11,142
Adjustment due to RFF/MAP	844	719
Loss-absorbing capacity of technical provisions	(18,030)	(20,003)
Loss-absorbing capacity of deferred taxes	-	(9,740)
Solvency Capital Requirement	**78,216**	**94,106**

The components of these risk modules are shown in section C of this report.

The SCR for each of the risk modules have been determined using a comparable approach with the prior year. There has been a material reduction in the market and life underwriting risk modules over the year – this is primarily due to the significant increase in interest rates over the year.

The calculation of Scottish Friendly's SCR has been carried out using the parameters of the Standard Formula. No undertaking-specific parameters were used.

No simplifications have been applied within the calculation of the SCR.

No capital add-on has been applied to the SCR calculated by Scottish Friendly.

Minimum Capital Requirement

The MCR has been calculated as the minimum of 45% of the SCR and the greater of 25% of the SCR and the linearly derived MCR.

The detail of the MCR calculation is shown below:

	2022 £000	2021 £000
Linear MCR	36,636	43,393
SCR	78,216	94,106
MCR cap	35,197	42,348
MCR floor	19,554	23,527
Combined MCR	**35,197**	**42,348**
Absolute floor of the MCR	3,445	3,126
Minimum Capital Requirement	**35,197**	**42,348**

E.3 Use of the duration-based equity risk sub-module in the calculation of the Solvency Capital Requirement

Scottish Friendly is not using the duration-based equity risk sub-module.

E.4 Differences between the standard formula and any internal model used

Scottish Friendly has not used an internal model or partial internal model in the calculation of the SCR.

E.5 Non-compliance with the Minimum Capital Requirement and non-compliance with the Solvency Capital Requirement

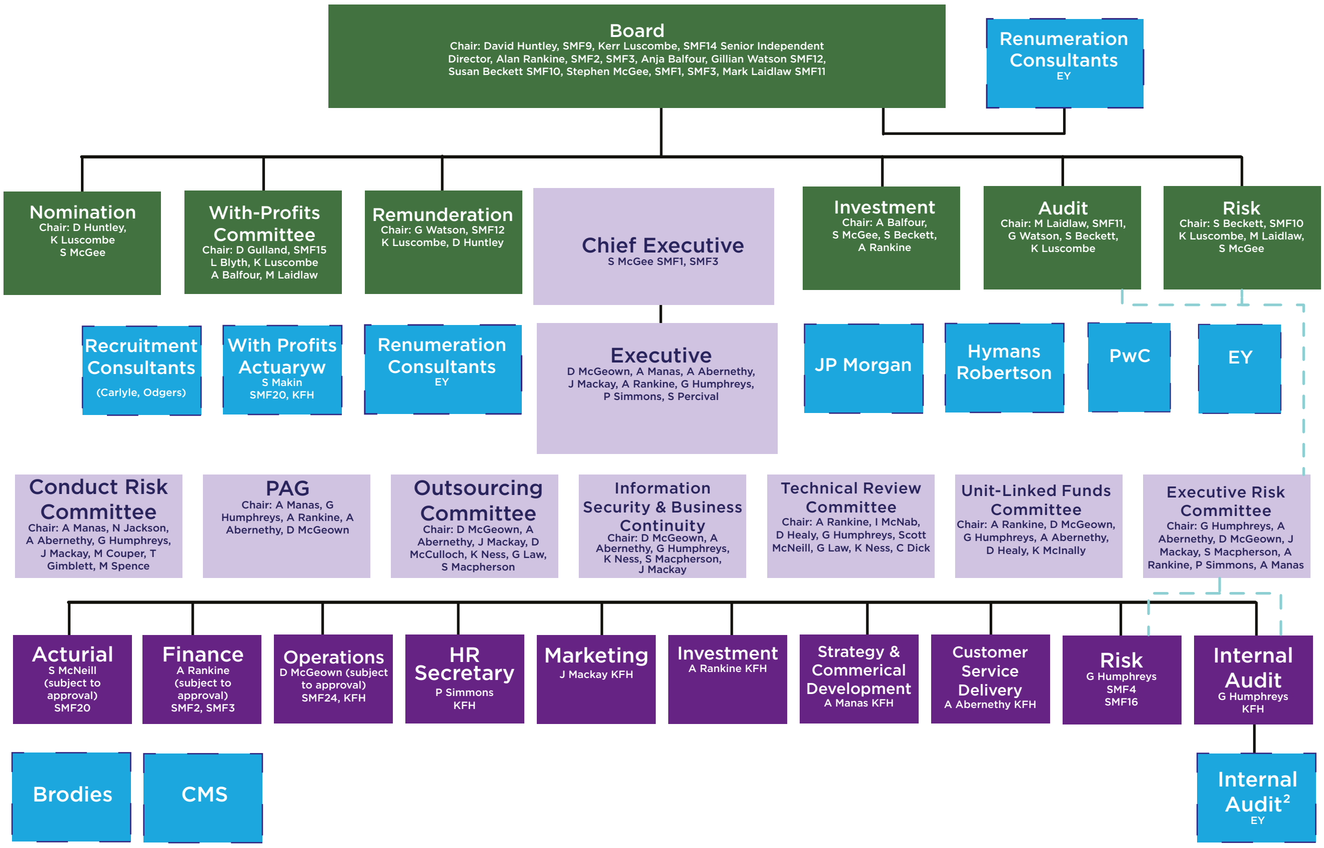
Scottish Friendly has complied with the MCR and the SCR throughout the period.

E.6 Other Material Information

There is no other material information to disclose in respect of capital management.

F
Appendices

F.1 Appendix – Functional Structure as at 31 December 2022



Board
Executive
Key Business Function
External

[1]List of external advisors is not exhaustive in that others are called upon as required, driven by project

[2]Outsourced functions

Note that in the diagram above Alan Rankine, Scott McNeill and Damian McGeown are all shown subject to regulatory approval. This approval was subsequently granted for all three individuals in Q1 2023.

F.2 Individual Performing Function (as at 31 December 2022)

SMF / KFH	Regulator	Individual Function	Performing Function
SMF / KFH	Regulator	Individual Function	Performing Function
SMF1	PRA	Chief Executive function	Stephen McGee
SMF2	PRA	Chief Finance function*	Alan Rankine (subject to regulatory approval which was subsequently granted on 11 January 2023)
SMF3	FCA	Executive Director	Stephen McGee
SMF3	FCA	Executive Director	Alan Rankine (Subject to regulatory approval which was subsequently granted on 11 January 2023)
SMF4	PRA	Chief Risk function*	Genevieve Humphreys
SMF9	PRA	Chair	David Huntley
SMF10	PRA	Chair of the Risk Committee	Susan Beckett
SMF11	PRA	Chair of the Audit Committee	Mark Laidlaw
SMF 12	PRA	Chair of the Remuneration Committee	Gillian Watson
SMF14	PRA	Senior Independent Director	Kerr Luscombe
SMF15	FCA	Chair of the With-Profits Committee	David Gulland
SMF16	FCA	Compliance*	Genevieve Humphreys
SMF17	FCA	Money Laundering Reporting	Aileen Abernethy
SMF20	PRA	Chief Actuary function	Scott McNeill (subject to regulatory approval which was subsequently granted on 11 January 2023)
SMF20a	PRA	With Profits Actuary function*	Stephen Makin

SMF / KFH	Regulator	Individual Function	Performing Function
SMF24	PRA	Chief Operations Function	Damian McGeown as interim Head of IT and Change (subject to regulatory approval which was subsequently granted on 28 February 2023)
KFH	PRA	Internal Audit Function**	Genevieve Humphreys
KFH	PRA	Investment	Alan Rankine
KFH	PRA	Marketing	Jill Mackay
KFH	PRA	IT	Damian McGeown as interim Head of IT and Change
KFH	PRA	Strategy and Commercial Development	Alexander Manas
KFH	PRA	Human Resources	Pamela Simmons
KFH	PRA	Customer Service Delivery	Aileen Abernethy
KFH	PRA	Customer Experience	Aileen Abernethy

* Denotes SMF's that are mandatory key functions.

** Genevieve Humphreys is the Key Function Holder for Internal Audit however the prescribed responsibility sits with Mark Laidlaw, Chair of the Audit Committee.

Notes:

1. Anja Balfour does not hold a SMF role under the regime but retains the role of non-executive director.

F.3 Public Quantitative Reports Template

The following public Quantitative Reports Templates (QRTs) are disclosed:

S.02.01.02	Balance Sheet
S.05.01.02	Premiums, Claims & Expenses by line of Business
S.12.01.02	Life & Health SLT Technical Provisions
S.23.01.01	Own Funds
S.25.01.21	Solvency Capital Requirement
S.28.01.01	Minimum Capital Requirement