



# Report to With-Profits Policyholders

2023

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## 1. Introduction

- 1.1 The Financial Conduct Authority's ('FCA') Conduct of Business Sourcebook ('COBS') requires a firm to establish and maintain Principles and Practices of Financial Management ('PPFM') documents which detail how it manages its with-profits sub-funds.
- 1.2 COBS also requires a firm to produce an annual report to its with-profits policyholders. This report should state whether the firm believes it has complied with its obligations, as set out in each PPFM, and provide an explanation for that conclusion.
- 1.3 Scottish Friendly has published separate PPFM documents which cover the management of the Unitised With-Profits ('UWP') policies and Conventional With-Profits ('CWP') policies written within the Main Fund. In addition, separate PPFM documents have also been published for the Rational Shelley ('RS'), LANMAS, Scottish Legal Life ('SLL'), Marine & General Mutual ('M&GM') and the Manulife sub-funds. These documents are available electronically on the Scottish Friendly website: [www.scottishfriendly.co.uk/PPFM](http://www.scottishfriendly.co.uk/PPFM).
- 1.4 The PPFM documents set out "principles" and "practices" which guide the management of the with-profits funds:
  - Principles – these are high-level statements that reflect the general approach adopted in managing the with-profits fund and are not expected to change often.
  - Practices – these are statements of specific practice employed in managing the with-profits fund and reflect the specific circumstances and established ways of managing each fund. Practices could be revised in response to changes in the regulatory, business, and economic environment and as new methods and techniques are developed in the life and pensions industry.

1.5 This report covers the period from 1 January 2023 to 31 December 2023 (inclusive), including the bonus declaration announced in January 2024. It describes:

- changes to the PPFMs made during 2023;
- details of governance arrangements for with-profits business;
- how Scottish Friendly has managed competing or conflicting rights, interests and expectations; and
- how Scottish Friendly has complied with the PPFMs in exercising discretion.

## **2. Overall conclusion**

2.1 The Board of Scottish Friendly ('the Board') has reviewed the operation of the with-profits funds for 2023 and in its opinion the PPFMs have been complied with in all material respects.

2.2 It is also the Board's opinion that the exercise of discretion over the period was appropriate, took account of policyholders' reasonable expectations and maintained fairness between different groups of policyholders.

2.3 In coming to this view the Board has taken account advice from the With-Profits Actuary, the With-Profits Committee and the Chief Actuary.

### 3. Changes to PPFM in 2023

3.1 Some PPFMs were revised over 2023 to add additional clarity to the documents and aid understanding, or to reflect enhancements which were made to business operating practices over the year. The main changes were:

PPFM	Notable changes
Main Fund CWP	<p>Section 4: Clarify tax charges made to policies (where applicable) are on a basis appropriate to mutual life insurance.</p> <p>Sections 4 &amp; 5: Updated wording to reflect practice in determining payouts on Whole of Life policies (see section 6.10)</p>
Main Fund UWP	<p>Section 5: Addition of wording to clarify practice for bonus declaration frequency in normal circumstances (See section 6.2)</p> <p>Section 9: Revision of practice for applying charges to policyholder unsmoothed values (see section 6.26)</p>
M&GM	<p>Section 4: Added wording to reflect practice in determining payouts on Whole of Life policies (see section 6.10)</p> <p>Section 6: Clarified wording relating to rounding practice when calculating market value reductions ('MVRs').</p> <p>Section 7: Clarified bonus series policy grouping practice</p>

3.2 These updated PPFMs were approved by the Board in December 2023 and published from January 2024.

### 4. With-Profits Governance Arrangements

4.1 The Board is ultimately responsible for ensuring with-profits business is managed in compliance with Scottish Friendly's PPFMs. To support the Board in discharging this responsibility, it has established a With-Profits Committee ('WPC') and appointed a With-Profits Actuary ('WPA')

- 4.2 Over 2023, the With-Profits Committee consisted of five members, who bring a wealth of diverse industry experience. It is chaired by a person who is entirely independent of Scottish Friendly and its Board, with one further independent member, as well as three further members who also sit on the Board of Scottish Friendly as Non-Executive Directors. It provides challenge of the Chief Actuary / With-Profits Actuary's proposals and additional oversight of the fair treatment of with-profits policyholders. The terms of reference for this committee are available on the Scottish Friendly website<sup>1</sup>.
- 4.3 The With-Profits Actuary gives advice and recommendations to the Board and With-Profits Committee on matters relating to with-profits business. This has included an assessment of compliance with the PPFMs and the oversight of communications provided to policyholders.
- 4.4 The With-Profits Actuary role was previously outsourced to Mr. Stephen Makin FFA of Hymans Robertson LLP. Over 2023 this role was brought in-house with Mr. Callum Stuart FFA being appointed as With-Profits Actuary (SMF20a) from 4 August 2023.
- 4.5 The Board took advice from the WPC and WPA on all key aspects related to the management of with-profits business over the period.
- 4.6 A report from the With-Profits Actuary to with-profits policyholders is annexed to this report. The With-Profits Committee has considered this report and has decided that an additional report specifically from the With-Profits Committee is not required.

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<sup>1</sup> <https://www.scottishfriendly.co.uk/about-us/board-committee-terms-reference>

## 5. Managing Competing or Conflicting Rights, Interests and Expectations

5.1 As Scottish Friendly is a mutual there is no need to consider conflicting interests of policyholders and shareholders. Nonetheless, there is an inherent conflict between ensuring the ongoing financial security of the Society and maximising policyholder payouts. In addition, a conflict arises as ultimately a decision taken in relation to the management of one cohort of business will inevitably have an impact (to a greater or lesser degree) on some other cohort of business.

5.2 Examples of competing or conflicting rights, interests and expectations include:

- Policies of different sizes / values.
- Policies with different maturity dates or different entry dates.
- Different types of policies – for example life or pension policies.
- Policyholders of different ages.
- Intra-fund considerations, where the Main Fund undertakes activities on behalf of one of the closed sub-funds.
- Policies claiming for different reasons (for example surrender claims compared to claims at maturities).
- Balancing the ongoing financial security of the with-profits fund against maximising the payouts to the current generation of policyholders.

5.3 Judgement and discretion is required to balance the competing interests of these various groups and ensure fair outcomes for all policyholders. The most significant application of discretion arises in:

- Determining appropriate cohorts of policies to share experience when setting bonus rates and surrender values.
- The application of smoothing when determining final bonuses.

- 5.4 Depending on how discretion is exercised, these different groups could receive varying benefits relative to each other. Any conflicts that arise are considered by the Board based on advice from the With-Profits Actuary, the Chief Actuary and the With-Profits Committee.



## 6. Compliance with PPFM and Exercise of Discretion in 2023

### Bonus policy

- 6.1 The approach used to determine bonus rates, including in relation to the application of smoothing, is summarised in the relevant PPFMs. Scottish Friendly typically applies regular bonuses which increase policy guarantees each year, as well as final bonuses which are added at the point of claim.
- 6.2 The Board approved a change in bonus philosophy in December 2023. Previously UWP final bonuses had been updated quarterly, but going forward these will typically be updated annually (albeit may change more frequently if there is significant investment under/outperformance). This will provide UWP policyholders with more predictable smoothed outcomes and improve customer experience. CWP final bonuses are typically reviewed annually and this approach will remain unchanged.
- 6.3 The most recent bonus declaration was completed and approved by the Board in December 2023, and was implemented on Scottish Friendly's administration systems in January 2024. In general terms:
- There was an increase in annual bonuses where these were supportable, reflecting higher interest rates since the last declaration.
  - The Main Fund final bonuses were broadly unchanged from those which applied in 2023.
  - The final bonuses which will apply in the M&GM and SLL sub-funds were higher than those which applied in 2023 – this is primarily as a result of the recommendations to increase the distribution of the estate in those sub-funds (see below).
  - The final bonus applicable to the Manulife sub-fund was reduced, primarily as result of poor investment performance over the period.

## Determination of payouts

6.4 An unsmoothed value is calculated for each policy which reflects the actual performance of the sub-fund. The unsmoothed value depends on various factors, including:

- The initial investment amount (after any withdrawals)
- Duration of the investment
- Performance of the sub-fund
- Associated charges and costs
- Tax implications (if any)
- And any other profits or losses within the Society.

6.5 Final bonuses are calculated by consolidating the unsmoothed values of similar investments (typically based on the date of investment). For most classes of with-profits business, Scottish Friendly endeavour to pay a value that reflects the aggregate unsmoothed value to ensure that fairness is maintained between different groups and generations of policies. As detailed below, the exception are Rational Shelley and Manulife policies. The PPFM contains target ranges for maturity and surrender payouts relative to the unsmoothed value.

6.6 The target ranges for each class of business are detailed below:

Policy Group	Target Range
Main Fund Ordinary Branch ('OB')	80% to 120% unsmoothed value
Main Fund Industrial Branch ('IB')	75% to 200% unsmoothed value
SLL	70% to 130% unsmoothed value
LANMAS	80% to 120% unsmoothed value
M&GM CWP	80% to 120% unsmoothed value
M&GM UWP	90% to 110% unsmoothed value
RS	Not applicable as the unsmoothed values are calculated based on bonus rates
Manulife	Not applicable as unsmoothed values are calculated based on bonus rates and surrender values are formulaic.

6.7 The target ranges are set so that the business can be appropriately managed by allowing flexibility in the setting of bonus rates to smooth returns when markets are volatile, and to give confidence to policyholders that payouts will be fair. Scottish Friendly sets our bonuses with the aim of keeping the majority of our payouts within the applicable target range.

6.8 Some target ranges, such as SLL and Main Fund IB, are wider than for the other policy groups listed above. For Main Fund IB and SLL there is a greater number of whole of life policy claims which means that it is more difficult to achieve payouts within a small target range.

6.9 During 2023 the payouts for maturities and surrenders for the majority of policy groups were within the target ranges. For groups where payouts were outside the target ranges the reasons for this are understood and there is no implication that these payouts, in aggregate, were unfair.

6.10 In 2023 work was completed to re-state some unsmoothed values for older whole of life policies in the M&GM sub-fund and Main Fund where historic data was more limited, as well as to correct some legacy issues identified with the unsmoothed values for some pensions policies in the M&GM sub-fund. Consequently, this has allowed the process for determining surrender values to be updated to directly consider individual policy unsmoothed values.

## **New business volumes**

6.11 New business is written in the Scottish Friendly Main Fund only. All sub-funds are closed to new business.

6.12 The volume of new business written over 2023 was broadly in line with Scottish Friendly's new business plan. In addition, the mix of new business was also monitored closely over the year to ensure this was aligned with the planned business mix. This monitoring demonstrated that new business sales were profitable and there was no detriment to the interest of with-profits policyholders.

6.13 Scottish Friendly undertakes an annual assessment to ensure that existing policyholders are not adversely impacted by the planned sales of new business over the coming year, in accordance with the requirements set out in COBS 20.2.28. This assessment was presented to the With-Profits Committee and Board in December 2023.

6.14 This assessment concluded that new business volumes planned for 2024 are consistent with the requirements set out in COBS 20.2.28. In particular, this assessment demonstrated that planned new business sales will be profitable and that writing this new business in the Main Fund is aligned with the interests of current and future generations of with-profits policyholders.

## **Investment strategy**

6.15 The guidelines for the with-profits investment strategy can be found in the relevant PPFMs.

6.16 The Board has established a sub-committee ('the Investment Committee') which is responsible for monitoring investment performance and setting investment strategy.

- 6.17 The Investment Committee meets at least quarterly and monitors the investment performance and asset allocation at each meeting. This includes ensuring that the assets backing unsmoothed values are invested in accordance with requirements set out in the PPFMs.
- 6.18 The latest asset allocation and investment position of each of the sub-funds, as well as the investment returns achieved by the sub-funds over 2023, can be found on the Scottish Friendly website at [www.scottishfriendly.co.uk/help-support/investment-information/asset-mix](http://www.scottishfriendly.co.uk/help-support/investment-information/asset-mix).

## Management of Estate

- 6.19 Where a sub-fund has an excess of assets over liabilities this is referred to as the “estate”. The permissible uses of the estate, and the approach used to manage the estate, are described within the PPFMs of each sub-fund.
- 6.20 The use and possible distribution of the estate of each sub-fund has been reviewed over 2023 in accordance with Scottish Friendly’s excess surplus policy. This concluded that there was no excess surplus in the RS and LANMAS sub-funds, but the SLL and M&GM sub-fund were in a position to distribute part of the estate as excess surplus. This conclusion was also supported by the run-off plans for the SLL and M&GM sub-funds which were updated in December 2023.
- 6.21 In December 2023 the Board approved a recommendation from the Chief Actuary to recommence distribution of the estate within the SLL sub-fund, and accelerate the distribution of the estate within the M&GM sub-fund. This is being distributed as follows:

Fund	Rate of Distribution of Estate
SLL	<ul style="list-style-type: none"> <li>Unsmoothed values uplift by 5.8% p.a; plus</li> <li>A 10% uplift to unsmoothed values at point of claim.</li> </ul>
M&GM – Flexible Income Annuity (‘FIA’) policies	<ul style="list-style-type: none"> <li>unsmoothed values uplift by 3.0% p.a (applied annually, from April 2024).</li> </ul>
M&GM – non-FIA policies	<ul style="list-style-type: none"> <li>unsmoothed values uplift by 4.25% p.a.</li> </ul>

6.22 In addition, the Board approved a recommendation to increase the Special Member Share within the Main Fund and distribute miscellaneous surplus to with-profits policies in the Main Fund by uplifting their unsmoothed values by 2%.

## Charges and expenses

6.23 The majority of Scottish Friendly's product lines are managed on a "charges" basis, where the amount taken from unsmoothed values is either in line with the contractual charges as specified in the policy term and conditions, or as was stated within the Scheme of Transfer when the sub-fund was acquired by Scottish Friendly.

6.24 The exceptions to this are:

- CWP business in the Main Fund and SLL sub-fund (the latter because the rate card specified within the Scheme of Transfer has now expired); and
- With-profits business in the Manulife sub-fund (where costs incurred by Scottish Friendly are substantially lower than the maximum permissible amount set in the Scheme of Transfer).

6.25 These product lines are charged an amount based on the actual costs in administration of the business (including a proportionate share of overheads). This allocation is based on the analysis of expenses used for Scottish Friendly's wider business planning activity.

6.26 Prior to 2023 a true-up had previously been applied to UWP unsmoothed values in the Main Fund to reflect actual expenses incurred in administration. The Board approved a change in approach from March 2023 such that UWP unsmoothed values will now be charged an amount equal to the fund management charge set out in contractual terms and conditions, with no retrospective true-up applied. The Board also approved the recommendation that the small true-ups previously applied should be refunded to unsmoothed values.

6.27 A paper was presented to the With-Profits Committee in March 2024 which set out analysis of the costs incurred in management of the business over 2023 compared to the charges deducted from unsmoothed values. This recommended a small true-up to CWP business in the Main Fund which was applied to the member surplus account.

6.28 This analysis gave explicit consideration to fairness between different cohorts and product lines, as well as fairness of the amounts charged to each of the sub-funds.

## **Business Risk**

6.29 Scottish Friendly's with-profits policyholders in the Main Fund ultimately bear the risks and rewards of all business undertaken by Scottish Friendly. Any significant additional business risks to be undertaken by Scottish Friendly require the approval of the Board and Executive, acting on the advice of the With-Profits Actuary. The Board and Executive take into consideration the risks to which with-profits policyholders are and may become exposed, as well as the expectations of achieving appropriate returns for the with-profits policyholders commensurate to the risks borne.

6.30 With-Profits policyholders in other sub-funds are also, although to a lesser extent, exposed to business risks as new business and acquisitions are not written into the sub-funds. The returns in each sub-fund are independent of one another and therefore reflect the risks taken in each sub-fund by the with-profits policyholders.

6.31 Business risks are monitored continually throughout the year, and the Board (on advice of the Chief Actuary and With-Profits Actuary) approves management actions required to protect the security of the with-profits funds and limit any adverse impact on with-profits policies. No material management actions were required during 2023.

## Annex: Report from the With-Profits Actuary

### ***Report from the With-Profits Actuary to the with-profits policyholders of Scottish Friendly Assurance Society Limited***

*The management of with-profits business requires discretion to be exercised, for example by deciding on the bonus rates to apply in determining policy pay-outs.*

*As With-Profits Actuary for Scottish Friendly Assurance Society Limited (“Scottish Friendly”), I advise the firm on key aspects of how this discretion is exercised. I am also required to report to the with-profits policyholders every year on whether, in my opinion, Scottish Friendly’s annual report to the with-profits policyholders and the discretion exercised by it over the same period take into account in a reasonable and proportionate manner the interests of with-profits policyholders.*

*I was appointed as WPA with effect from 4 August 2023 following a detailed handover from Stephen Makin FFA who held the post from 29 May 2019. Either Stephen Makin or I, as WPA, were involved in consideration of all the matters referred to in the attached report on Scottish Friendly’s compliance with its PPFM. I have carried out a review of Scottish Friendly’s exercise of discretion and its compliance with the requirements of its PPFM for the SF Main Fund and each of the notional sub-funds.*

***In my opinion, the discretion exercised by the Directors of Scottish Friendly over the period took your interests into account in a reasonable and proportionate manner and was consistent with disclosures to policyholders and the PPFMs.***

*I have based my opinions on the information and explanations provided to me by the outgoing WPA, the Directors and management of Scottish Friendly and on my own knowledge and investigations. In doing so I have taken into account the relevant rules and guidance issued by the Financial Conduct Authority, the Financial Reporting Council and the Institute and Faculty of Actuaries.*

***Callum Stuart FFA  
With-Profits Actuary, Scottish Friendly  
June 2024***