

Solvency and Financial Condition Report

Financial Year 2018

Solvency and Financial Condition Report 2018

Dear Members,

As the people responsible for your Society, the regulator requires us to report to you on the extent to which your benefits are secure in a document called the Solvency and Financial Condition Report ('SFCR'). I am delighted to present the SFCR for 2018.

We ensure that the Society is there for when you need it the most in two main ways. First, we make sure that the Society has a healthy financial position, now and in the future (called 'having sufficient capital'). Second, we make sure that we run the Society properly (called 'having effective governance'). This report describes the work we have done in 2018 to demonstrate that we have sufficient capital and have effective governance.

Running any business involves risk. There is always a risk that the finances deteriorate or that we fail to run the Society properly. We, the Board, are obliged to take every reasonable step to ensure that we identify and manage the risks that the Society faces.

The SFCR is organised into six sections. The sections and their contents are set by the regulator. We have added explanatory boxes throughout this year's report to explain any new terms as they are used and have summarised them in a glossary at the end. We have deliberately avoided technical language, but have sometimes had to strike a balance between the regulatory requirements and keeping things simple.

I hope you enjoy reading this report. We are always delighted to discuss the Society with our Members at the Annual General Meeting or at any other time. If you have any comments, questions or suggestions, please do not hesitate to contact me.

Summary

Business and Performance

The Society has performed well during 2018. Sales have grown substantially, 98% of claims received have been paid, and overall underwriting performance has been maintained. We have drawn down on our investments to support new business and to pay for the development of our new computer system, called PRISM. The balance of our investments have performed less well, reflecting a difficult year for investment markets. Our spending is in line with our plans.

Our strategy is to grow by providing useful products to new and existing Members. We sell our products through intermediaries, so it is important that intermediaries know us and feel confident recommending our products. That means we have to be competitive and have to show how we improve the lives of our Members. Our rebranding work was an important part of getting us better known in our market.

We achieve our strategy through our business model. This is jargon for how we will be successful. Our view is that our best chance of success is to develop new products and product features that Members and intermediaries see as attractive and which are competitively priced. We think we should manage our underwriting and claims handling ourselves, because we have expertise in this work.

A major part of our plan is to build PRISM. This is a significant project and work is well under way.

We are particularly pleased with the growth in Membership during 2018. This growth has been achieved following a repricing of our most popular products and the success of a pilot scheme to inform Members better about their options when they contact us.

Finally, given that we are relatively small, our business model includes buying in specialist services which we cannot carry out ourselves.

As a result of our strategy, business model and plans, we expect to grow the value of the Society for our Members.

Risk Profile

All insurers manage risk. It is management's job to organise the affairs of their firm to ensure that benefits can be reliably paid when an insured event happens and a claim is made.

The regulator wants to know that insurers understand the risks that they face. It has created a formula for insurers to use that calculates the cost of the risks being run based on the nature of the firm. If the firm has enough capital to cover the calculated cost, the benefits are estimated to be at least 99.5% certain over the year following the calculation. We think that this formula is the best way of measuring the Society's cost of risk from the methods available.

We have performed the necessary calculations. The work indicates that **we have more than enough capital to ensure that Members' benefits will be paid** over the next twelve months (which is the regulatory requirement). The Board is satisfied that it will continue to be able to meet claims as they fall due in future.

The formula identifies the source of the risks that each firm faces, and calculates a cost for each of them. Using this formula in 2018, we have established that our biggest risks arise with worsening sickness experience or if sales turn out differently to the plan. Other major risks are economic: e.g. some Brexit scenarios, a 30% drop in equity markets or a 1% drop in interest rates.

We continually manage these risks, as well as all of the other risks that we face.

Managing Our Risk Profile

Risk is managed by having sufficient capital and having an effective system of governance. **We have sufficient capital and an effective system of governance.** This report sets out how we have concluded that this is the case.

Having Sufficient Capital

Every year, we review the benefits that we owe to Members and the assets that we have to meet them. We allow for future premiums on existing policies, for expected sickness and for a proportion of Members to stop their policies. This review is called the annual valuation. There are a number of rules that have to be followed to make sure that the valuation is right.

The valuation proves that the Society has enough capital to meet Member benefits.

We calculate the risk in the Society's business using the formula mentioned earlier. The cost of risk amount is called the Solvency Capital Requirement or SCR. It is a measure of how much extra capital the Society needs to be 99.5% sure that it can meet all Member benefits in the next year. If an insurer has more capital than the SCR, the chance of there being a problem is even lower than 99.5%. We have more capital than the SCR.

The Society's Valuation

This year, our valuation showed a healthy buffer of assets over liabilities. This buffer is called, in regulatory jargon, 'Own Funds'.

The SCR is the capital needed to cover the cost of the risks calculated by the formula. While we followed the rules to calculate the SCR and we think the number we calculated is correct, the regulator reserves the right to disagree and may ask us to change it.

Surplus capital is regulatory jargon for the difference between Own Funds and the SCR. The surplus capital provides extra protection to Members and is available for other purposes, such as investment in the Society's strategy.

Table 1 shows that the Society has more than £20m of surplus capital when it has allowed for the standard-formula cost of risk.

Table 1: Surplus Capital, £000		
	31 Dec 2018	31 Dec 2017
(a) Own Funds	57,461	50,704
(b) Solvency Capital Requirement ('SCR')	36,876	27,825
(c) Surplus Capital (a) – (b)	20,585	22,879

The surplus capital is lower than at the start of the year, because we have sold more business (giving a bigger SCR), because stock markets were low at the end of 2018, and because money has been invested in developing the Society.

We expect our surplus capital to reduce over the next year as we invest more in new business and in developing the Society. This new business will mean that the SCR in 2019 will increase and the surplus capital will fall. The Board will continue to monitor the SCR and the surplus capital, to ensure that risk does not grow too high and that capital does not fall too much.

The regulator classifies capital into tiers, depending on how reliably the capital can be called upon. All of the Society's capital is Tier 1. Tier 1 capital is the best quality capital (the most reliable).

The regulator sets a minimum level of capital called the Minimum Capital Requirement or MCR which, for the Society, is around one quarter of the SCR. If an insurer's capital falls below the MCR, the regulator will intervene. We are a long way from our capital being below this level.

In conclusion, we have more than enough capital to confidently support the payment of Member benefits.

Having an effective system of governance

The Society has an effective system of governance.

Pay is properly managed. Steps are in place to make sure that those working for the Society, especially at a senior level, are fit and proper. The risk management system has been reviewed this year and is effective. An Own Risk and Solvency Assessment has been performed. This work has been useful in helping the Board and others make decisions.

The internal control system has similarly been reviewed and strengthened. The Society has effective compliance, actuarial, risk management and internal audit functions.

Our Independent Auditor is PricewaterhouseCoopers LLP, unchanged from last year.

Our Internal Auditor is Ernst & Young LLP, newly appointed for 2018.

The actuarial function continues to be provided by OAC plc.

We continue to monitor those firms to whom we have outsourced services.


In conclusion, we are satisfied that our system of governance is effective, given the nature, scale and complexity of the Society's risks.

Our responsibility

The Directors are responsible for preparing this, the 2018 Solvency and Financial Condition Report, so that it meets the regulator's financial reporting rules and the rules that apply to insurance companies (called Solvency II regulations). The Directors are also responsible for making sure that the working environment is robust enough to ensure that this report is accurate and free from any material mistakes, from any cause, including fraud or someone's error.

We are satisfied that, throughout 2018, the Society complied in all material respects with the requirements of the regulators' rules and the Solvency II regulations. It is reasonable to believe that the Society has continued to comply since and will continue to do so in future.

M J Day
Chairman
and Director
17 April 2019



Stuart Tragheim
Chief Executive
and Director
17 April 2019



Paul Harwood
Company Secretary
and Director
17 April 2019



A. Business and performance

A.1 Business

The Original Holloway Friendly Society Limited ('the Society') exists to provide a replacement income when you, one of our Members, cannot work because of illness or injury (which we call 'sickness'). We protect your income when you cannot work and try to help you get back to work, where we can.

We currently offer four income protection (or 'IP') products. Each protects your income up to a pre-agreed amount. Each protects you until your chosen retirement date, provided you keep paying the premiums.

One of our products pays out for up to one or two years (called 'Short Term Income Protection') for any single cause. The other two pay out until your chosen retirement date. Short Term Income Protection is cheaper because the benefit payment period is capped and it has different features, so it appeals to different people.

Our 'Purely Protection' and Short Term Income Protection products have premiums that increase with age, according to a pre-agreed schedule. The cost of your protection increases, hopefully as your income increases.

'one2protect' has level premiums, which are guaranteed for five years from the policy start date. The premiums may then be varied, depending on how sick, or not, people with this product have been. If there have been a high number of claims, the premiums will increase. If there have been a low number of claims, the premium will be reduced. one2protect, unlike the other products, has different premium levels depending on your job.

We offer a Holloway product. This product pays you an income if you cannot work, with an additional benefit of some savings and the right to share in the profits generated by these products. As a result of this feature, this is a With-Profits (or 'WP') product.

What is a Holloway product?

We understand that we were the first firm to combine income protection and savings. The resulting innovative product, introduced in the 1880s, was named after our founder, George Holloway.

We used to offer a group life (or 'GL') product, issued by a company that the Society owned. This company, called HF Life Ltd, was branded as Optimal. The group life product provided the death-in-service benefit that many employers offer to their employees. We closed Optimal to new business in 2017. As its policies were mostly for one year, they came to their natural end or were transferred throughout 2018. There are no Optimal policies in force as at 1 January 2019.

We may, in the future, offer new products or adjust or stop offering existing products.

As you might realise, this is a simplified description. Our products are available only through appropriately qualified financial intermediaries who can explain them, including how they can be adjusted for your needs and what options are available. Intermediaries act for you, not for us, although we do pay commission to them for every new product which is bought. Intermediaries can offer products from a range of providers, not just from us.

We manage a number of products, some of which are no longer available. These can be divided into four types: Income Protection (or IP) products (like the first four mentioned earlier), With-Profits (or WP) products (the Holloway product is a with-profits product) and Unit-Linked (or UL) products. In 2018, we managed the remaining Group Life (or GL) products sold through Optimal to their expiry or transfer.

The Unit-Linked product is closed to new business. The Unit-Linked product was a savings plan where the benefit was linked to investment performance.

Everyone who has a product issued by the Society becomes a Member. People with products issued by Optimal did not become Members.

The Society is owned by its Members. It has no shareholders. Therefore, everyone at the Society works for you, our Members. The Society's Board of Management ('Board') makes decisions on your behalf. You elect the Directors who serve on the Board.

What is a Board?

Most companies are run by a Board of Directors. These are the people who direct the company, decide its strategy and ensure its governance. The Board oversees plans, performance and activity and, if not satisfied, makes changes.

The Board is chosen by the owners of the company. For us, the Board is chosen by you, our Members.

Transformations included the completion of the introduction of a new product called one2protect, continuing the improvement in governance, rebranding the Society, continuing the recruitment of high-quality people, developing sales and the refurbishment of the head office. Work continued to design and build PRISM.

The Society has Members throughout the UK, the Channel Islands and the Isle of Man. It offers its products throughout the UK and in the Isle of Man.

We are, legally speaking, a friendly society, registered and incorporated under the UK Friendly Societies Act 1992 with the registered number 145F. We are authorised and regulated by the Prudential Regulation Authority ('PRA') and regulated by the Financial Conduct Authority ('FCA'). Our Firm Reference Number ('FRN') is 109986, which you can use if you want to write to either regulator.

The PRA is responsible for our prudential regulation. You can contact the PRA by writing to Prudential Regulation Authority, 20 Moorgate, London, EC2R 6DA or by calling 0207 601 4878. The FCA is responsible for regulating our conduct. You can contact the FCA by writing to the Financial Conduct Authority, 12 Endeavour Square, London, E20 1JN or calling 0207 066 1000.

Our independent auditor is PricewaterhouseCoopers LLP ('PwC'). PwC can be contacted by writing to 2 Glass Wharf, Bristol, BS2 0FR or telephoning 0117 955 7779.

What is an independent auditor?

An independent auditor is a firm appointed mainly to provide independent assurance to Members that a Society's accounts are broadly accurate.

In 2016, the Board took time to assess the future of the Society. The Board decided that it wanted to grow the Society and to provide its products to more people.

This ambition required the Society to grow. To grow, we had to change how we worked. 2018 was the second year in a five-year plan to grow the Society by increasing the number of Members, by the value of the policies being administered, and by reach. We are pleased to be able to report success in all three areas.

A.2 Underwriting Performance

What is underwriting?

Underwriting is the process of assessing someone's health and lifestyle to decide the best protection that we can offer and the cost and conditions of this protection.

Underwriting success can be judged by the difference between premiums received and claims paid. Underwriting is effective if the premiums received are greater than the claims paid. Table 2 shows the premiums and claims for the four product types described earlier (Income Protection (IP), With Profit (WP), Unit Linked (UL) or Group Life (GL)). Reinsurance is included and is explained a little later.

Table 2: Underwriting Performance – Group £000

	IP		WP		UL		GL		Total	
	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017
Premiums (P)	3,653	2,846	3,024	2,976	0	0	217	1,553	6,894	7,375
Reinsurance	-	-	27	(58)	-	-	(15)	(24)	12	(82)
Claims	(722)	(334)	(816)	(757)	(107)	(71)	(175)	(1,129)	(1,820)	(2,291)
Surplus (S)	2,931	2,512	2,235	2,161	(107)	(71)	27	400	5,086	5,002
% Surplus (S÷P)	80.2%	88.2%	73.9%	72.6%	n/a	n/a	12.4%	25.7%	73.8%	67.8%

Key: IP = Income Protection, WP = With-Profit, UL = Unit-Linked, GL = Group Life

Income Protection business has a particularly healthy underwriting result. Very little new Holloway (or With-Profit) business was sold in 2018. The results primarily include Members claiming their investment balances. The Unit-Linked products are closed to new business and have all completed their premium-paying term. The Group Life business (Optimal) was closed to new sales in 2017, so the figures reflect the run-off of that business in 2018. 'Reinsurance' is the difference between reinsurance premiums paid and recoveries received.

Overall, a healthy underwriting surplus was generated for the Society. The surplus meets the Society's expenses, including strategic expenses, or is retained as value for Members, current and future.

Reinsurance was very important for Optimal, but is much less so for the remainder of the business.

What is reinsurance? part 1

Reinsurance is insurance for insurance companies. An insurer can use reinsurance to reduce its own risk, to provide technical support and to help with cash flow. Reinsurance is provided by specialist firms called reinsurers.

The insurer pays a premium to the reinsurer. In return, it receives money from the reinsurer for claims that are made.

Table 2 shows the impact of reinsurance on the results for With-Profit and Group Life business lines.

The reinsurance premiums paid in 2018 were much lower than 2017 as a direct consequence of the closure of Optimal to new business and the transfer of much of that business to another insurer. The claims paid are much lower for similar reasons. Optimal generated an underwriting surplus in 2017 but a small underwriting loss in 2018.

Underwriting in General

With more new Members, we have to underwrite more people. We have a dedicated team to do this work. We expect our underwriting standards to be maintained as we grow.

Managing claims is an important part of our work. We pride ourselves on working with Members to help them claim quickly and without fuss, and helping them get back to work as soon as they can. We take steps to ensure that our Members' assets are not subject to fraud.

We continue to develop our underwriting and claims management facilities.

A.3 Investment Performance

We classify our investments into three categories: equities (shares), fixed interest (bonds) and cash and property. Table 3 below shows how our investments have performed over 2018.

Table 3: Investment Performance, During 2018 & 2017 £000s								
Return Type \ Asset Type	Equities		Fixed Interest		Cash and Property		Total	
	2018	2017	2018	2017	2018	2017	2018	2017
Realised Capital Loss/Gain	(95)	1,019	(169)	210	1	-	(263)	1,229
Unrealised Capital Loss/Gain	(3,857)	833	(606)	(260)	2,321	57	(2,142)	630
Income Received	410	732	509	562	54	67	973	1,361
Investment Expenses	(97)	(86)	(94)	(72)	(22)	(8)	(213)	(166)
Total	(3,639)	2,498	(360)	440	2,354	116	(1,645)	3,054

During the year, we changed our equities and fixed interest managers, following a tender process. LGT Vestra LLP took over the management of these investments from Investec Wealth and Investment Limited, in June 2018. At around the same time, we divested our holdings in funds managed by Royal London and the proceeds were transferred to LGT Vestra LLP.

Throughout the year, cash has been held in three high-quality deposit accounts or the Society's trading bank accounts. During the year, some cash was moved to the LGT Vestra LLP cash fund.

At the end of the year, we held no securitised assets (this is a type of investment. The regulations say that we must let you know if we hold them).

A.4 Material Income and Expenses

Our main source of income is premiums from Members. We receive income from reinsurers when we pay claims for policies that are reinsured. Details of this income are in section A.2.

We receive income from our investments. Details of this income are in section A.3.

The Society has habitually rented out part of its Head Office and allocated associated expense to the rental income received. As the Society has grown, it has used more of its Head Office, to the point where now it has sole occupancy. During 2018, it bore a small loss on the rental account of £3,583 (2017: profit of £5,891). We do not expect any future income or loss from this source in future.

Table 4 shows the Group's expenses. We have not included investment expenses because these are described in section A.3.

Table 4: Expenses – Group £000			
Product Type	2018	2017	% change
Commission	3,093	1,103	180%
Sales-related Expenses	5,084	3,459	47%
Maintenance Expenses	1,795	1,184	52%
One-off Expenses	383	1,869	-80%
Claims Handling Costs	306	162	89%
Total Expenses	10,661	7,777	37%

Commission has increased in line with the increase in new business. Sales-related expenses has increased by a lower amount in 2018 than commission because much of the increase to generate higher sales was incurred in 2017. Similarly, maintenance expenses have increased.

The one-off expenses in 2017 principally cover consultancy and design of PRISM. In 2018, consultancy expenses were much lower.

Claim handling costs have increased. More people have been recruited to support claims, in line with the increase in them.

A.5 Any Other Information

Performance of other activities

Nothing additional to report.

B. System of Governance

What is governance?

Governance covers everything to do with being sure that a business is running properly. It includes legal requirements, the need to be fair to Members, and the need to organise the business sensibly and with due regard for risk.

B.1 General Information on the system of governance

What is a system of governance?

For the Society, this means everything that is in place to make sure that the Society is well governed.

We have an effective system of governance in place. It ensures that we manage the Society safely and reliably. The system of governance reflects our size, product range and our historic expertise in the work that we do. The system of governance for a large company is different to that of a small one. It is important that the approach chosen fits the company. We think that ours does.

Regulation asks for three things in the system of governance: (a) a transparent organisational structure, (b) clear and appropriate segregation of responsibilities, and (c) a well-established and effective system for ensuring the transmission of information. We have these in place. In short, (a) all of our colleagues know what their jobs are and who does what, (b) we don't allow people to do and check their own work or to do work where there might be a conflict, and (c) we work hard to make sure that everyone knows what is going on, and if not, that it is clear where to go for help.

The system of governance is regularly reviewed by the Board and its Audit and Risk Committee.

What is the Audit and Risk Committee?

The Board has set up Committees to help it with its oversight work. The Audit and Risk Committee oversees internal and independent audit, compliance, actuarial and risk management activities. It ensures that the risk management and internal control systems are effective. Details of its terms of reference (the rules it follows) are on our website.

About The Board

The Board is made up of a small group of people, called Directors, who, together, run the Society at a high level. The Board is chosen by our Members and is responsible to them and to the regulators.

The Board is made up of Non-Executive Directors who are independent (principally, they don't work in the Society other than as Directors, nor do they have any personal interest* in it) and Executive Directors who work in the Society as well as being Directors. There are more Non-Executive Directors on the Board than there are Executive Directors. Thus, if it comes to a vote, Executive Directors cannot out-vote the independent Non-Executive Directors.

*All of the Directors have policies with the Society. As everyone knows about this, it is not believed to be a barrier to them acting and thinking independently. It is explicitly allowed in the Society's Rules.

The Board is made up of eight people: six Non-Executive Directors, the Chief Executive and the Chief Financial Officer.

The Board decides the strategy, hires the Chief Executive and other senior people, and monitors performance. The Board can consider anything it chooses. Mainly, it considers business plan, culture, financial and other reporting, the quality of the system of governance, risk management, the prudential management of the Society and its own succession. The Board is led by the Chair.

What is the Chair?

The Chair is the Non-Executive Director who leads the Board. It is an important role with specific responsibilities to the regulator and to Members.

There are three Board Committees which help the Board do its work. These Committees and the Board hold the Executive to account.

What (or who) is the Executive?

The Executive refers to the Chief Executive, the Sales & Marketing Director and the Chief Financial Officer.

These are the employees who run the Society, led by the Chief Executive, responsible to the Board.

The Nomination and Remuneration Committee is two committees sitting at the same time.

The Nomination Committee is, as at 31 December 2018, made up of five people: three independent Non-Executive Directors, the Chair and the Chief Executive. It considers the Board's performance and its current and future make up. The Remuneration Committee is made up of four people: three independent Non-Executive Directors and the Chair. It considers all aspects of pay, including Executive pay, and bonus plans (short-term, long-term and sales). This joint Committee meets at least twice a year. It helps the Board by making sure that the Board and its Committees work effectively, including having a plan for succession, and that there is effective oversight of pay and benefits.

The Investment Committee is, as at 31 December 2018, made up of six people: four independent Non-Executive Directors and two Executive Directors. It considers the selection and performance of our investments and ensures that they are invested according to the Prudent Person Principle. The Committee meets at least twice a year. It helps the Board to have confidence in the approach to investment and performance of investment managers.

What is the Prudent Person Principle?

This is a phrase in the regulations. It means that investments should be only those that a prudent person would make.

The Audit and Risk Committee (or 'ARC') is made up of four people: three independent Non-Executive Directors and the Chair. It considers the effectiveness of our financial management, risk management and internal controls systems and the controls around compliance. The Committee draws on the work of the independent auditor, the internal auditor, the risk management function, the actuarial function and the compliance function. The Committee meets at least four times every year. It helps the Board have confidence in the quality of our system of governance and the accuracy of our financial statements.

Main Business Functions

There are three main functions of the business: sales and marketing, Member services and operations, and finance and risk.

The sales and marketing function is responsible for presenting the Society to Members and intermediaries before and after they have bought a product, dealing with press enquiries, writing and designing material, finding new intermediaries, agreeing commission rates and understanding what products and product features would be attractive to new Members. Its role is to make sure there is a healthy flow of new Members.

The operations function is responsible for the handling of the Society's Head Office activities involving Members and their policies. It includes dealing with Members, underwriting, administration and handling claims when Members cannot work. This function keeps the IT systems going and manages new IT developments. It looks after all aspects of the Head Office building. It is responsible for disaster recovery planning, that is, how the Society would cope in an emergency. It handles people management and project and change management. In summary, its role is to handle all aspects of managing products after sale, as well as the computer systems, buildings and so on.

The finance and risk function is responsible for the money, be it money coming in (as premiums), money being paid to Members who are ill or injured, or money being paid to cover wages, suppliers, training, insurance, consultancy fees etc.. Part of this responsibility is the proper accounting for every penny received and spent. The finance and risk function is responsible for the Society's risk management systems (does the Society understand the risks it is running?, has it thought about how to manage risks to prevent a problem?), which includes the compliance function (does the Society comply with the rules?) and the company secretarial function (are Board and Committee meetings being run properly?) and liaises with independent and internal audit and the actuarial functions. Its role is to ensure that the Society is managed and controlled to the high standards expected of an insurer.

How the system of governance has changed during 2018

The system of governance was extensively refreshed in 2017. In 2018, the refreshed system started to become embedded. A number of compliance and internal audit investigations were performed and new policies covering Conduct Management and Supplier Management were agreed by the Board.

A new Non-Executive Director was appointed to the Board.

The Executive Committee, which had been a Committee of the Board, was formally converted to a management committee. This Committee was and is responsible for the Society's day-to-day performance, management policy, and matters which need attention but which are not important enough (yet) to need Board attention. Its role is to support the Chief Executive. It was felt to be the right time to alter its status.

The Compliance Officer is responsible for compliance, money laundering and other financial crime prevention and data protection. He currently serves as the Head of Internal Audit reporting to the Chair of the Audit and Risk Committee. The Chief Finance Officer is the Board-appointed Director responsible for Money Laundering and Fraud Controls.

The General Data Protection Regime was implemented in May 2018. Certain aspects of the International Distribution Directive came into force from 1 October 2018. We have taken steps to ensure compliance with these new rules.

A new regulatory regime was introduced in December 2018 called the Senior Managers and Certification Regime. This regime allows the regulator to hold named Senior Managers to account to the regulators. We have four named Senior Managers and four named Non-Executive Directors who are Senior Managers under this regime.

Review of the System of Governance

The Board and its ARC have continued to monitor the performance of the System of Governance and to suggest changes where necessary.

Every three years, Boards are expected to be reviewed by someone who is independent and external, to ensure that the Board and its Committees are effective. The Society's Board last underwent this process in September 2017. The next process is scheduled for 2020.

Remuneration Policy and Practice

We will only be successful if our people work hard and do a good job. The Society's future is in the hands of its employees, whom we call colleagues, who need to be rewarded properly for doing a good job.

The Society's approach to paying its employees is set out in its Remuneration Policy. Our Remuneration Policy tries to make sure that the right behaviour at work is rewarded. This is a balance between continuing doing everyday work to the right standards and coping with the changes that growth requires.

We have a clear idea why the Society exists (to be there when Members need us the most – our mission) and what it has to be if it is to grow (to be the most recommended provider – our vision). We have a clear idea of what makes the Society special (our values). The Remuneration Policy supports the mission, vision and values and tries to recognise and reward those who support them through their behaviour at work.

Rewards have to be in proportion to the overall success of the Society. They have to reflect each person's contribution.

Our Remuneration Policy is based on the following:

- there needs to be a balance between achievements and risk taking
- rules must be met, values demonstrated and standards maintained
- no-one should benefit through an accident or because the rules did not cover every possible situation (so payments are discretionary),
- everyone should have the opportunity to earn a bonus based on how well they work.

Pay at the Society is made up of (i) salary, benefits and pension, (ii) either a sales incentive plan or an annual bonus plan and (iii) a long-term incentive plan.

(i) Salary, benefits and pension are paid to all Society employees.

The salary, benefits and pension are competitive. They are regularly compared with the pay and benefits of similar organisations, at every level.

Benefits include car allowance, private medical and dental and other standard benefits (death-in-service, paid holiday, sick pay etc.). The benefits offered differ according to role and seniority.

(ii) The sales incentive plan is open to all colleagues working directly in the sales function. All other colleagues directly employed by the Society are eligible for the annual bonus plan.

The sales incentive plan generates bonuses based on quarterly and annual sales performance, and performance on a number of conduct and capability measures.

The annual bonus plan requires threshold sales and expense targets to be hit. If they are, a bonus becomes payable depending on performance against a number of numeric and activity targets.

(iii) The long-term incentive plan is open to selected members of the Executive Committee.

The long-term incentive plan considers performance over three-yearly periods. It pays a bonus if the Society's value is higher than agreed targets each year for three years. Any bonus is decided upon after each three-year period is over, is at the Remuneration Committee's discretion, and is paid over the two years following the end of the performance period. There are two such plans in place, for performance periods 2017-2019 and 2018-2020.

The Purpose of Remuneration

We use pay to attract and keep good people who have the skills and experience that the Society needs to grow. Salary, pension and benefits are set in comparison with similar firms and to attract people to the Society.

The annual bonus plan and the sales bonus plan should encourage the activities needed for the Society to grow.

Terms of Appointment of Executive Directors and Other Members of the Executive

The employment terms, including pay, for the Society's most senior executive functions are overseen by the Remuneration Committee. No individual is involved in setting her or his own remuneration. We expect variable remuneration to form a significant part of Executive remuneration.

The long-term incentive plan should allow us to attract and retain Executives of the right quality, and should encourage them to focus on building the Society's long-term value. The Remuneration Committee is responsible for all payments under this bonus plan. It can choose to ignore the amounts calculated from the bonus formulas, and instead to increase or reduce bonuses payable. It is expected that this would only happen to fairly reflect contributions made, where not to do so would

be harmful to the Society's long-term success. The Committee can reduce, withdraw or claw back any payments under the long-term incentive plan in certain circumstances.

No executive service agreement has a notice period longer than one year and there are no loss-of-office or other benefits linked to resignation, except pay during notice periods. Any severance package for an Executive is subject to agreement by the Nomination and Remuneration Committee. There are no early retirement or supplementary pension schemes.

Terms of Appointment of Non-Executive Directors

Non-Executive Directors are paid on a fixed fee basis. The fees are set to reflect the work required of each individual (chairing committees etc.). Two Non-Executive Directors are eligible for healthcare benefits. These benefits are not currently offered to new Non-Executive Directors. The notice period is one month. There are no loss-of-office or other benefits linked to resignation from the Board. Re-election varies depending on time served, but no Director may serve for more than three years following their election at the Society's Annual General Meeting without re-election. Serving for more than nine years requires particular consideration. There are no early retirement or supplementary pension schemes.

Remuneration throughout the Society

The Remuneration Policy applies to all colleagues. The annual bonus plan is open to all non-sales personnel. The resulting bonus is expected to form no more than 60% of annual pay. The sales incentive plan is open to members of the sales team, but not senior sales management (who instead are part of the annual bonus plan). The resulting bonus is expected to form no more than 125% of annual pay.

Transactions with Connected Parties

During 2018, the Society did not do any paid work with people or firms which are closely connected with its Directors or senior managers.

B.2 Fit and proper requirements

We need members of the Executive and Senior Leadership Team to have the skills, knowledge and expertise to run the Society properly and to develop and implement our strategy. The most important quality is experience. Professional qualifications are important for some roles, as is a willingness to make the changes necessary to allow us to be there for our Members in their times of need and to demonstrate our strengths to intermediaries.

What is the Senior Leadership Team?

This is the group of people who work for members of the Executive. On a day-to-day basis, the Senior Leadership Team makes sure that the Society is properly run. Members of this team attend the monthly Executive, and some other Committee, meetings and, depending on their job, may occasionally attend or present at Board meetings.

Our Board ensures that those running the Society are properly qualified and have the knowledge and experience to do their work properly. They must have good reputations and have integrity. The regulator calls this being fit and proper. For the most senior people, the Nomination Committee ensures that applicants are fit and proper. For other roles, the Executive has this responsibility.

The regulator is kept up to date with all changes in senior management, including key function holders (the regulator's label for specific functions). We share the information used to confirm that someone is fit and proper. In particular, if someone was thought to be no longer fit and proper, we would tell the regulators.

When someone joins our Executive or Senior Leadership team for a role that requires regulatory approval, a specialist firm is hired to collect the information needed to decide whether they are fit and proper. This firm considers fitness mainly by validating statements made by the candidate, including qualifications earned. It considers probity by searching for indicators of poor behaviour, including criminal record checks. It asks for references from previous employers. The Board ultimately decides whether it feels that someone at this level is fit and proper. For these roles, having made its assessment, the Board has to propose the individual to the regulator to be approved before the person can begin in the role.

In all other roles, the checking process is tailored for the role.

B.3 Risk management system including the own risk and solvency assessment

(a) Risk Management System

Insurers are required to have an effective risk management system. It must include strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies. This statement of what must be covered by the risk management system is taken from the regulations.

We reorganised our Risk Management System completely during 2017. In 2018, we have continued to refine the system, based on its results.

Our Risk Management System is built around the business plan. Risks to the plan are automatically considered when the business plan is developed. The Risk Management System also covers the plans to improve governance and monitors the insurance risk elements of the Solvency Capital Requirement ('SCR').

What is the Solvency Capital Requirement?

This is the amount that the regulator says the Society has to hold to ensure policyholder benefits are secure in most circumstances over one year. It is calculated using a formula provided by the regulator. It is often shortened to SCR.

The size of the SCR depends on the cost of the risk in the business. Is a high cost of risk a bad thing? Only if you do not have enough capital to meet the cost of risk.

A higher cost of risk means a bigger SCR. If a firm can meet its cost of risk, any surplus capital provides extra security for Members or can be used for other purposes.

The Board is satisfied that the Risk Management System is effective. It is well integrated into the Board processes and is becoming embedded into other parts of the Society.

The Society's Risk Management System starts by defining the risks that the Society faces, split into risks to the business plan, governance risks, insurance risks (as defined in the SCR formula) and operational risks. A risk tolerance is defined for each risk. The tolerance links back to the business plan, governance plans, SCR and risk profile, or operational thresholds. Management then reports to the Board if one or more threshold is, or looks like it might be, exceeded.

What is a risk tolerance?

Most measures of performance have an expected value or target. The risk is that the actual value is higher or lower than the target, to an extent that might cause harm or cause the plan to be re-considered.

A risk threshold is, for a given measure, the value at which action is needed to prevent harm or to reconsider the plan.

The Executive team continually monitors risks, including operational risks, that come to light. Where appropriate, reports are made to the Board, to ensure that Directors are informed about risks materialising and about risk management.

What is operational risk?

Operational risk is the risk of some planned activity going wrong because a process fails, a system fails or someone does something wrong. Operational risk includes errors caused by processes, systems or people not doing something, as well as doing something wrong.

For insurers, the regulator suggests that fraud and legal problems are included as operational risks.

The Society maintains a risk register.

What is a risk register?

The Society's risk register is a list of the risks that it faces with details of how the risks are identified, measured, monitored, managed and reported.

We have established a management committee called the Risk and Controls Committee to review risk and internal control information, and to decide what should be passed to the Board and when. The risk management function is led by the Chief Risk Officer ('CRO'). As a member of the Executive, the CRO is always involved in discussions and decisions about strategy and tactics. The CRO makes sure that risk consequences are considered and sometimes has to respond to challenges about risk. Reporting is via the Risk and Controls Committee.

We regularly discuss how risk might affect outcomes and our solvency, even if no change is expected. We especially consider risk and the impact on solvency when developing new products.

What is solvency?

When a risk event happens, often (but not always) the simplest solution is money. Regulators recognise that the more surplus money a firm has, the more secure the policyholder benefit. 'Solvency' is the jargon used by insurers to mean the capital that a firm has in excess of that needed to meet Member claims in most circumstances.

Insurers talk about capital rather than money. Capital is defined a little later on.

When considering a risk, insurers look at the impact the risk might have on their surplus capital - hence, the impact on solvency.

Generally, high or increasing solvency is a good thing, low or declining solvency is a concern, unless the change was planned or there is a good reason for it.

When the Board or a Committee has a decision to make, the papers describing the decision include CRO comment. The CRO is expected to cover the impact of the decision on our risks and our solvency. The result is that the Board makes decisions in full knowledge of the possible impacts of the decision on risk, on solvency and on the system of governance, assuming different outcomes.

(b) Risk Management Function

Insurers are required to have a risk management function as part of their Risk Management System. The Society's Chief Financial Officer serves as CRO and runs the risk management function. The risk management function makes sure that the Risk Management System works properly.

The Society's Risk Management System is very tightly aligned to its business planning. Business planning includes considering how the Society might perform in different scenarios, including if its risks materialise. There is an overlap between business planning and risk management and thus the performance of both functions by the same person, given the Society's size, is sensible.

The CRO reports to the Chair of the ARC on risk matters and is a Director of the Society. These arrangements provide the authority necessary for the role.

The CRO regularly discusses the work required of the risk management function, its resources, and the Risk Management System, with the ARC.

(c) Own Risk and Solvency Assessment

What is an ORSA?

The regulation requires insurers to undertake an Own Risk and Solvency Assessment, or ORSA, whenever its risks change, or at least annually.

The ORSA is a judgement by the Board of the insurer's risks and the impact on the insurer's solvency. Importantly, it is the Board's view, not the regulator's (and not the view using the regulatory formula).

The starting point for the own risk and solvency assessment (ORSA) is the ORSA policy. This is a document required by the regulator to set out how an ORSA is to be done.

The ORSA process is a series of steps. The Board and others consider all of the risks that we face and their possible impact. The impact of each risk might be how it affects capital, how management have to behave to manage the risk, or a mixture of both.

What is capital?

Capital is the regulatory name for the resources available to meet the Society's outgoings.

For the Society, capital is made up of cash, investments and the difference between expected premiums less current and future claims and expenses.

We design a number of risk tests. Some just look at a single risk and suggest the extent to which it might occur. Others look at groups of risks occurring together. The tests are used to see the impact on the Society if risks occur as suggested. The Board considers the results and may ask for new tests when it sees what the first results reveal.

When the Board is satisfied that it has considered all possible risks, it can start to think about the right level of solvency given those risks. The question the Board is trying to answer is how much surplus capital we need to be confident that we can meet all Member benefits and withstand all of the risks that we face, given the business plan.

What is surplus capital?

Surplus capital is the capital over and above that needed to meet expected Member benefits and the SCR.

We then perform a number of routine checks before drawing up a draft ORSA report for the ARC to consider. Based on the ARC's views, a final report is presented to the Board. This includes the Board's proposal on the necessary level of surplus capital that we need to have confidence that Member benefits can be paid. Once agreed by the Board, the report is sent to the regulator.

Throughout this process, an ORSA record is kept containing details of the intermediate results and discussions on risk matters.

Once the ORSA report is agreed, the Board conducts a review of the process. The results of the review are fed into the review of the ORSA policy and the next scheduled ORSA.

The results of the ORSA have to be shared throughout the Society. Integrating the ORSA is part of the risk management function work described earlier.

The ORSA happens at least once per year. A new ORSA is organised immediately if our risk profile changes dramatically. In 2018, we performed the ORSA between September and November.

The ORSA is now considered as part of the Society's strategic planning and the results are routinely used in business decisions and business projections.

In conclusion, the Society has decided, following its 2018 ORSA, that it has enough capital to meet its needs over its five-year business plan (from 1 January 2017), given its risk profile. It is the Society's plan to operate within its own resources. We have no plan to raise capital, so plans for capital do not affect our planned risk management.

(d) Decision Making

Insurers are required to write down their decision-making procedure as part of their risk management system. We have done this.

We have taken steps to ensure that the Board does not make decisions without understanding the risks to that decision. One of the purposes of the Risk Management System is to ensure that all of the risks affecting major decisions are understood and that ways to manage or remove risks are considered before the decision is made. Thinking about risk as a day-to-day feature of decisions, rather than something separate, should improve the quality of Board and Committee decisions.

B.4 Internal Control System

(a) About the Internal Control System

Insurers are expected to have an effective internal control system.

We have an effective internal control system, which covers administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at all levels of the Society and a compliance function. These are regulatory requirements.

Our internal controls are generally managed by the person responsible for each function. These managers are responsible for making sure that there is the right mix of controls and for managing changes safely within their functions.

There is a regular meeting of managers to consider the Internal Control System. Senior leaders and members of the risk and compliance functions are invited. The nature of internal control and operational risk is discussed. Each manager assesses the effectiveness of their controls and discusses their plans to improve control where necessary. After each meeting, a report is produced for the Risk and Controls Committee, which in turn produces a report for the ARC.

The Head of Operational Risk is responsible for documenting and managing internal controls.

These structures and accountabilities (regulatory language) form the Society's internal control system.

In conclusion, the Board is satisfied that the Society has an effective internal control system.

(b) Compliance Function

The regulator requires that every insurer has an effective compliance function.

The compliance function advises the Board on the structures in place to ensure that the Society complies with the laws, regulations and rules of Solvency II and a range of other regulations. It considers changes in regulations and how they might affect the Society. The function considers the risk of non-compliance.

What is Solvency II?

Solvency II is the name given to the European regulations that UK insurers have to follow. It sets out what insurers have to do to protect policyholder benefits.

The areas discussed in this document are all required under Solvency II, as is the production of this document.

The compliance function has a programme of formal monitoring agreed in advance with the ARC. It reports progress on this, and any other, work at regular ARC meetings. It is available to all other functions of the Society to offer advice.

The Head of Compliance is appointed by the ARC and has a direct reporting line to its Chair and to the Chief Executive as well as a day-to-day reporting line to the Chief Financial Officer. These arrangements provide the authority necessary for the role.

The Head of Compliance is industry experienced and has access to external support should it be needed.

It is important that, while the Head of Compliance is employed by the Society, she or he can independently decide whether something is in accordance with the rules, without being swayed by her or his manager or by wider management. The Board is satisfied that the Head of Compliance has operational independence by his nature and professional training, and that it is maintained through the reporting line to the ARC.

The Society's planned compliance activities are set out in an annual compliance plan that is considered by the ARC. The activities selected for inclusion in the plan depend on the Head of Compliance's assessment of the areas that require review in the light of both the Society's business plan and emerging issues which may be unexpected but which have a compliance implication. The Head of Compliance regularly considers whether he has enough time and resource to ensure that the Society is appropriately compliant, and reports his conclusions on this subject to the ARC.

In conclusion, the Board is satisfied that the Society has an effective compliance function.

B.5 Internal Audit Function

The regulator requires that every insurer has an effective internal audit function.

The internal audit function considers the adequacy and effectiveness of the internal control system and other elements of the system of governance. It is objective and independent from the operational functions. These are regulatory requirements.

Internal audit performs an independent risk assessment and agrees what areas it will investigate with the ARC. It produces a report after each investigation describing its findings and its recommendations. This report is presented to management, which ensures that appropriate actions are taken within an appropriate timescale. A summary of activity and investigation results, including progress towards implementing the recommendations, is provided to the ARC by the internal audit function.

The internal audit function has, throughout 2018, been provided by an professional services firm called Ernst & Young LLP ('EY').

Over a multi-year cycle, EY agrees the areas to be investigated with the ARC and produces a work plan for the next year. During 2018, a number of investigations were carried out, covering the areas deemed highest risk by the ARC. A report was produced after each investigation as well as an annual report on our governance, risk and controls.

By using an external firm as internal auditor, we judge that internal audit is independent and objective. EY does not provide any additional services to the Society.

The Compliance Officer currently serves as the Head of Internal Audit. This role is primarily about liaison between the internal auditor and the ARC. This role acts for and reports to the Chair of the ARC. It includes a direct reporting line to the Chief Executive (for matters regarding Internal Audit). These arrangements ensure that the function has appropriate authority.

The Head of Internal Audit regularly considers whether he has enough time himself, and enough resource in terms of days of EY time, directed to internal audit work, and reports his conclusions on this subject to the ARC.

In conclusion, the Board is satisfied that the Society has an effective internal audit function.

B.6 Actuarial Function

The regulator requires that every insurer has an effective actuarial function.

What is an actuary?

An actuary is a specialist insurance mathematician who is trained in actuarial work.

Actuarial work tends to involve projecting events over the long term. Events include sickness, investment returns and expenses.

Actuaries use these projections to confirm the financial health of insurers.

We contract with an external actuarial consulting firm, OAC plc ('OAC'), to provide the actuarial function and to provide our Chief Actuary and With-Profits Actuary (currently the same person fulfils both roles). The contract is an annual one, which has been in place since 1 January 2010.

During the year, the ARC reviewed the provision of its actuarial services. After due consideration, the Society re-appointed OAC plc as actuarial function

and Christopher Critchlow as Chief Actuary and With-Profits Actuary.

The actuarial function carries out a number of tasks set out in the regulations and provides a number of required reports to the regulator on our behalf.

The Chief Actuary heads the actuarial function and reports to the Chief Financial Officer, with explicit additional reporting lines to the ARC. These arrangements ensure that the function has appropriate authority.

OAC maintains a small team focused on the Society's affairs, led by the Chief Actuary. Members of the team work for other OAC clients as well as the Society. OAC takes steps to ensure that any conflicts are managed, and it discusses these with the ARC. OAC liaises with the Society's finance function to plan work required and to ensure that there is sufficient resource available to perform it to the appropriate standard. The Chief Actuary reports his conclusions on this subject to the ARC.

The Chief Actuary liaises with the ARC and the Board throughout the year, especially when there are decisions to be made that require actuarial advice.

The Chief Actuary is always available to members of the Executive and Board to discuss matters of actuarial interest.

By using an external firm, we judge that the actuarial function is independent and objective.

In conclusion, the Board is satisfied that the Society has an effective actuarial function.

B.7 Outsourcing

We outsource some functions of our business, including:

- investment services
- computer system development (part)
- hosting of web-based services
- telephone interviewing and data collection, to aid underwriting
- internal audit (see B5)
- actuarial services (see B6)

In all cases, we remain fully responsible to our Members for the quality of the service.

We do not outsource critical or important operational functions or activities if we judge that the result would be a poorer system of governance, would unduly increase operational risk, would reduce the regulator's ability to oversee the extent of our compliance with its rules, or would undermine continuous and satisfactory service to Members.

We outsource typically to UK-based organisations, although some work may be done elsewhere in the EU or the world. In these cases, we take steps to ensure that the provider agrees that no personal information is sent outside the EU without proper measures to keep it safe.

We alert our regulator prior to any outsourcing of critical or important functions or activities as well as to any subsequent material developments regarding those functions or activities.

B.8 Any Other Information

Nothing additional to report.

C. Risk Profile

The Society's risks are not unusual. They are managed transparently.

C.1 Underwriting Risk

We don't know who will buy our products. Underwriting is, as described earlier, how we assess someone's health and lifestyle so that we can decide the best protection that we can offer and the cost and conditions of that protection. Underwriting risk is the risk that the people who buy our products are different from those that we expect. We may find that we have charged too much or too little, we might not apply the right extra conditions, or might apply them incorrectly.

Nature of Underwriting Risk

The nature of our underwriting risk has changed as our new business has increased and as we have made changes to our underwriting approaches. During 2018, we have continued to review and monitor our underwriting standards. We always monitor experience carefully, and consider changes to our processes or assumptions as a result.

What is experience?

Insurers make a lot of assumptions in their planning and projections. Experience is the term used to describe what actually happened rather than the assumption that was made.

Managing Underwriting Risk

We regularly compare the sickness and other benefit payments that are made with those that were assumed when the products were designed and that are assumed in the annual valuation. If the number, value or duration of claims is higher than assumed, we will consider whether changes need to be made, and if so, what they should be.

What is a valuation?

Every year, we are required to calculate the value of the policies that we administer, primarily to make sure that we have enough capital to meet the benefits that are due to Members. This process is called the valuation.

We use a rich set of data for underwriting. Only some of this data is used in the valuation. Often the data is not stored in ways that can be used in a valuation system. We are taking steps to develop the data stored so that more relevant data can be used in the valuation.

During 2018, we commissioned an internal audit review of Underwriting. We also contracted with an external underwriting expert to review other aspects of our underwriting. Both of these reviews will report in 2019. We look forward to learning from their results.

We continually review our claims procedures to ensure that they are effective for Members.

The most significant risk for the Society's business is that of worsening sickness experience compared to the product pricing. This might arise because more Members are sick and/or are sick for longer.

We assess the risk of worsening sickness by close monitoring of new claims and active management of existing claims. We mitigate it by better underwriting at point of sale, better pricing and effective underwriting at claims stage.

The risks in our products are controlled by the product terms and conditions. The financial consequences of these risks materialising depend on the product chosen. In some cases, the Society pays a benefit until the policy ends. In others, it pays for a maximum of two years.

Most of our products have guaranteed premium rates, so it is important that the experience is as close as possible to that expected.

We do not offer products with significant options, so there is no chance that more Members than expected could decide to choose an option and so generate a significant cost for the Society.

We do not allow for expected investment returns when we set our product prices.

Reinsurance

We have not generally used reinsurance, other than for Optimal, although we may do in future. The reason we don't is (for Income Protection policies) because we have a strong track record of underwriting and of managing sickness claims for the policies that we sell.

We have some reinsurance in place, to protect us from a sudden increase in claims on certain product types, but it has very little financial impact.

There was a reinsurance policy in place throughout 2018 covering all of the Optimal business. Now that there are no live Optimal policies in force, this reinsurance policy has ended. There is a theoretical chance that a claim on an Optimal policy could still

be made, in which case, the reinsurance would still pay out.

There are four other long-standing reinsurance arrangements, all of which operate properly, but overall have a negligible effect on our financial position. Details of the reinsurance that we have are in section D.2 section 8.

What is reinsurance? part 2

Reinsurance, as described earlier, is insurance for insurance companies. Insurers are always responsible to their policyholders for the risk that they take on.

Reinsurance might offer security for insurers, especially when the products being sold are new. This explains why we have very little reinsurance for our income protection business (which we have been selling for many years), but we did have reinsurance for our Optimal business, which was much younger.

Risk Sensitivity

The Society is sensitive to more or fewer Members becoming sick, or Members being sick for longer or shorter periods. Table 5 shows the impact on Surplus Capital of changes in numbers of spells of sickness, or duration of time off work, or the lifespan of Members.

Table 5: Impact of Changes to Assumptions on Surplus Capital, Underwriting £000			
		2018	2017
Surplus Capital as at 31 December		+20,585	+22,879
Assumption	Change	Impact	Impact
Spells of sickness	10% less sickness	+1,267	+729
	10% more sickness	(1,267)	(729)
Length of sickness	Sickness bouts are 10% shorter	+3,812	+2,280
	Sickness bouts lasts 10% longer	(5,600)	(3,397)
Death rate	10% more Members die	+240	+215
	10% fewer Members die	(253)	(153)

The Impact column shows the change in Surplus Capital

Outlook

Underwriting risk is expected to increase as a result of the Society’s growth plans. We will be underwriting more business for different types of product.

C.2 Market Risk

Market risk is the risk that assets do not perform as expected. Usually, market risk refers to assets falling in value. The size and nature of our market risk depends on the assets that we hold.

We expect to use our assets to meet future commission for new business and to meet ongoing expenses, as well as providing Member benefits, in 2019. As a result, there will be smaller asset balances to be invested. If we decide to invest these smaller asset balances in cash and fixed interest assets, rather than equities, the cost of market risk calculated using the regulatory formula will be lower.

Ideally, assets are selected which match liabilities. For example, assets can be matched to liabilities by nature (if the liabilities are inflation linked, the assets should be inflation linked), by term (if the liabilities are expected to be due in one year, the assets should be chosen to perform at the one-year point), by currency (if the liabilities are in sterling, the assets should be too).

What is an asset and a liability?

Accountants talk about assets and liabilities.

For the Society, our policies are labelled as liabilities. They are the commitments we have to meet.

The accumulated premiums less outgoings are labelled as assets. We use the proceeds of the assets to meet the liabilities.

Matching to the nature of our liabilities is difficult for us, because there is no obvious factor that can be identified in the liability profile which can be matched in the asset profile. There is no asset that increases in value when someone cannot work.

Matching by term is difficult, but not impossible. We may have to pay a benefit tomorrow, or in 50 years’ time, and have to be able to do both. We can work out roughly how much we might be called upon to pay and at what times, based on assumptions about the future. We know, from our business plan, how much we expect to spend on commission and day-to-day expenses. With this information, we can make sure that we strike the right balance between immediately available, short-term assets and assets invested for the longer term.

Matching by currency is straightforward. All of our liabilities are denominated in Great British Pounds (‘GBP’), so we match by investing in GBP-denominated assets. We buy some non-GBP asset, where we judge that the extra return promised outweighs the currency mismatch risk (we have time to convert them to GBP before the cash is needed).

We mitigate market risk by ensuring that our investment policy is set with a proper understanding of the nature of the Society's liabilities and its future cash demands, by specifying the degree of diversification required, selecting suitable benchmarks and by monitoring the activity of the selected investment managers.

We invest in a wide range of assets to reduce the chance that poor performance or the failure of a single asset could have a significant impact on the performance overall. Section D.1 describes the portfolio in terms of the different types of asset.

Sometimes, we hold equities and bonds that are issued by the same firms. Our biggest holdings by value are set out in Table 6 below:

Table 6: Equities By Holding, £000					
		2018		2017	
Rank	Asset	Equity Value	Bond Value	Equity Value	Bond Value
1	Lloyds Banking Group plc	207	519	633	152
2	Royal Dutch Shell plc	468	182	721	-
3	HSBC Holdings plc	374	250	427	212
4	Tritax Big Box REIT Plc	522	-	-	-
5	Aviva Plc	290	217	-	-
	Balance of portfolio	14,059	11,324	18,455	12,313
Total		15,920	12,492	20,236	12,677

53% of the equities we hold are denominated in sterling. 34% and 4% are denominated in US Dollars and Euros respectively. The remaining 9% are denominated in other currencies.

Risk Sensitivity

The Society is sensitive to changes in a number of economic factors. Table 7 shows the impact on Surplus Capital of changes in these factors.

Table 7: Impact of Changes to Assumptions on Surplus Capital, Investment £000			
		2018	2017
Surplus Capital as at 31 December		+20,585	+22,879
Assumption	Change	Impact	Impact
Risk-free Yields	Risk-free yields increase by regulatory shock	(6,630)	(3,828)
	Risk-free yields reduce by regulatory shock	+3,273	+1,689
Fixed Interest	fixed interest assets fall by 10%	(1,848)	(1,938)
Equities	equity values fall by 10%	(1,592)	(2,024)
Property Values	property values fall by 10%	(94)	(80)

The Impact column shows the change in surplus capital

Required Statements

There is no dependency between different risks of different insurance obligations. We have no off-balance-sheet exposures. We do not use any techniques to mitigate the natural performance of assets and liabilities.

There is no mismatch between asset and liability by term or currency. There are no deliberate mismatches permitted.

Outlook

Market risk is expected to reduce over the business plan term because the value of assets is expected to reduce as more money is paid out as commission for new business, to meet the higher expense base and as an investment in the Society's strategy, and the assets are expected to move to less volatile asset categories.

C.3 Credit Risk

Credit risk is the risk that someone owes you money and cannot pay.

We invest some of our cash with banks and into cash funds. This is a credit risk – the risk that the banks or funds cannot repay our money with the agreed interest on demand. We think that this risk is low because we only use banks and funds with higher credit ratings and we spread the money around to avoid concentration in just one firm or fund.

Table 8: S&P Credit Rating of Fixed Interest Assets and Cash, £000

Asset	31 Dec 2018		31 Dec 2017	
	Value	%age	Value	%age
AAA	0	0%	0	0%
AA	1,929	11%	2,185	11%
A	5,338	30%	6,930	34%
BBB	8,093	46%	9,307	45%
Investment Grade Total	15,360	87%	18,422	90%
BB	497	3%	570	3%
B	183	1%	202	1%
Non-investment Grade Total	680	4%	772	4%
Unrated	1,535	9%	1,398	6%
Total	17,575	100%	20,592	100%

Table 8 shows that, during 2018, the bonds held have been moved towards the middle of the credit rating band: fewer non-rated and AAA/AA-rated bonds and an increase in BBB-rated bonds.

We mitigate credit risk by investing in a diverse pool of assets, using professional investment managers to ensure good market understanding.

Other Sources of Credit Risk

Credit risk exists with intermediary commission balances and reinsurance recoveries.

We pay commission to intermediaries assuming that a number of premiums will be paid by the Members that they introduce. If a Member ceases to pay premiums early in the policy lifetime, we expect the intermediary to re-pay some of the commission that they received. This is a credit risk – the risk that the intermediary will not have the money. We think that this risk is low because we choose intermediaries carefully and continually monitor the amounts owing. As sales have grown, the size of this risk has increased.

We have some agreements with reinsurers. We expect them to pay a proportion of claims on some products. This is a credit risk – the risk that the reinsurer cannot pay us. We think that this risk is low because we only use reinsurers with the higher credit ratings.

C.4 Liquidity Risk

What is liquidity and liquidity risk?

Liquidity is the term used to describe how easy it is to get hold of cash when it is needed.

Liquidity changes when the economy changes: for example, when property is hard to sell, it is illiquid.

Liquidity risk for us occurs when a benefit cannot be paid because we cannot physically get hold of the cash to pay. We take steps to make sure that this can never happen, as far as we can tell.

Liquidity risk arises if we cannot pay a claim when it falls due because we could not physically provide the cash, even though we have enough cash in the bank and sufficient other assets.

Our sources of cash are premiums, investment income, sale of investments, reinsurance payments and the surpluses that we generate. Generally, premiums are a reliable and high quality source of liquidity. The liquidity expected from investment income and assets sales depends on the instructions we give to investment managers. We want to invest in high quality assets with good liquidity, but we know that we don't need all of our assets to be in cash immediately. By investing to match the expected claims by timing, we can increase the return expected without affecting our ability to pay Member benefits.

We invest our cash and deposits across reputable institutions with high credit ratings, and thus high liquidity, over the short term. The quality is measured by each bank's or fund's credit rating. We choose a mix to reduce our reliance on a single bank or fund. We have a significant holding in a cash fund run by LGT Vestra LLP. We believe that this fund is diverse and well managed.

Surpluses are a further source of liquidity, but these will already be invested in one or more of the assets mentioned.

As a result of this management, our liquidity risk is low and is expected to remain low.

C.5 Operational Risk

Operational risk is a wide category of risk. It is the risk of something going wrong. This might be people working in the Society doing things wrong, or not doing things that they should. It might be a process that is faulty or a process that is missing. It might be a computer program that goes wrong or a computer system that crashes. It might arise from a fraud, from a reputational failing or from poor strategy. There doesn't tend to be an upside from operational risk.

Our exposure to operational risk is high because we are changing so much of what we do. Change always invokes risk, because things don't always go to plan. We seek to manage operational risk by planning carefully, thinking about risks, and managing people and projects with sensitivity and understanding. We try and make sure that we consider what might go wrong before we make a change, that we test and check things while in development, and that when a change is finally introduced, we monitor it carefully to make sure the expected result is achieved.

The SCR Operational Risk calculation is determined by a regulatory formula.

We measure operational risk through the Internal Control System (see B.3). By its nature, we are managing a number of often-very-different risks under the heading of operational risk. The measures used are particular to the individual risk.

The impact of operational risk on the business plan is considered in the ORSA. For most operational risks, when they materialise, the effect is on the level of sales or expense or both.

We have no particular concentration to operational risk. We protect ourselves against legal challenges (using directors' and officers' insurance), and fire, theft etc. (using an appropriate insurance policy).

The Society's risk management and internal control systems make sure that operational risk is managed to acceptable levels.

C.6 Other Material Risks

(a) Material Risks

We assess material risks in our ORSA. We consider the business plans and the areas where results are uncertain. We then consider the range of possible results within normal conditions allowing for individual risks and for groups of risks happening together. The risks that have the greatest impact on solvency are the most material risks.

Underwriting risk (C.1) and market risk (C.2) are material for us. We have to monitor sickness experience carefully, and there are certain economic situations, including possible Brexit scenarios, that could severely affect our financial position.

Other material risks that we face are:

(i) Lapse risk: higher lapses than expected

(ii) Expense risk: spending more than expected

(iii) Discovery of an unknown risk

What is a lapse?

When a member decides not to continue with their policy, we say that the policy has 'lapsed'.

Policies may also end because the Member dies, the Member reaches retirement or the policy reaches its maturity date.

Every policy that lapses leaves fewer to bear the remaining expense. Thus, lapse risk and expense risk are connected.

There is no obvious concentration of risk, other than by product. Product risk is implicit in how we operate. We will always aim to sell a large volume of the products we offer.

(b) Assessing and Mitigating Material Risks

(i) Lapse risk: higher lapses than expected

We assess lapse risk by closely monitoring premium collections and other processes which might lead a Member to decide not to continue with their policy.

Lapse risk is mitigated by prompt service, sensitive review of individual cases (recognising that lapse may be appropriate in some circumstances) and by thinking about how to ensure that Members keep their policy going where it is sensible for them to do so.

(ii) Expense risk: spending more than expected
Expense risk is spending too much. We assess this risk by monitoring spending against budget.

We mitigate it by planning and careful use of resource.

We recognise that the eventual cost of PRISM is hard to estimate. We mitigate this uncertainty through planning and appropriate challenge, and through robust testing.

(iii) Discovery of an unknown risk

The Board has to assess all of the Society's risks continually. That said, there is the possibility that an unexpected risk emerges. A risk assessment would be incomplete if it did not mention this possibility.

(c) Liquidity Risk

The regulators require us to note that the valuation of the income protection policies includes expected profit in future premiums of £57.606m (2017: £36.696m). This is important because this amount is available to meet Member benefits over time regardless of how liquid our assets are. That said, this amount is generated over the lifetime of the policies, so it may not be available when it is needed. Other ways of managing liquidity risk have to be considered.

(d) Assets and Prudent Person Principle

We invest our assets in line with the Prudent Person Principle, as required by regulation.

We ensure this by carefully selecting investment managers and designing their instructions to cover the security, quality, liquidity and profitability of the assets they select. Assets are always invested in our view in the best interests of Members.

We only invest in assets where we can properly identify, measure, monitor, manage, control and report, and appropriately take into account their risks in our assessment of solvency.

C.7 Any Other Information

Nothing additional to report.

D. Valuation for Solvency Purposes

D.1 Assets

The value of our assets on a Solvency II basis is shown in Table 9:

Table 9: Solvency II Assets, at 31 December £000		
Asset Type	31 Dec 2018	31 Dec 2017
Property – Office, Own Use	800	800
Equities – Listed	9,029	11,466
Bonds – Government	4,609	4,938
Bonds – Corporate	9,637	8,597
Bonds – Other	158	157
Tangible Assets	142	168
Collective Investment Undertakings	11,072	13,813
Assets Held for Unit-Linked Contracts	915	1,124
Cash on Deposit	3,525	6,056
Cash with Investment Managers	45	2,446
Cash at Bank and in Hand	534	176
Reinsurance Recoverables	0	77
Other	222	628
Solvency II Asset Value	40,688	50,446

The office property is revalued every three years by a qualified valuer at open market value and a desktop valuation in the interim. It was last valued in November 2017.

Equities, Government Bonds and Collective Investment Undertakings are valued using quoted market prices in active market provided by third party pricing sources

Corporate and other bonds are valued using prices from a single broker. The prices are thus from an external source.

Cash and Cash Equivalents are included at face value.

There have been no changes to the valuation approach used and no significant exercise of judgement in arriving at the values shown.

The Society holds no unlisted equities, derivatives, loans or mortgages. Reinsurance Recoverables as at the balance sheet date are shown in the 2018 financial statements (see www.holloway.co.uk) as are leasing arrangements. The Society has no deferred tax assets.

We use the same bases, methods and main assumptions to value assets for solvency purposes as we use in our financial statements, other than the exceptions shown below in Table 10 which reconciles the differences.

Table 10: Society Asset Reconciliation, £000		
	31 Dec 2018	31 Dec 2017
Value of assets presented in financial statements	62,190	54,393
Intangible assets: policy administration system	(1,359)	(270)
Intangible assets: product and software development	(71)	(210)
Prepayments	(96)	(106)
Technical provisions gross of reinsurance, excl unit-linked	(19,977)	(3,361)
Solvency II value of assets	40,688	50,446

31 Dec 2018 column does not add up exactly, due to rounding

The rules for considering solvency are different from the rules for presenting financial information. The solvency rules are concerned with policyholder protection. The financial information presentation rules are concerned with providing a true and fair view. One difference in practice is that what can be treated as an asset is different. Solvency assets cannot include intangible assets (for us, work done to develop products or systems that are not yet live) and some prepayments. Solvency assets cannot include technical provisions.

D.2 Technical provisions

We have to calculate two numbers that measure the value of our policies: the Best Estimate and the Risk Margin. Added together, these numbers are called the Technical Provisions.

The Best Estimate is the Society's realistic assessment of every policy's worth when administered by the Society. The Best Estimate includes a small adjustment called 'Incurred but not reported' which is described a little later on.

The Risk Margin is the extra money that someone else would require to take on the Society's policies and look after them, in the same way that we do. It is calculated using a formula set by EIOPA, the European Insurance and Occupational Pensions Authority, a European regulatory body.

The Technical Provision calculations are done by the actuarial function. The approach is well established.

We have to calculate the Technical Provisions for all of our policies. Since the Society began in the 1800s, it has offered a number of different products. We continue to administer all of these for as long as our Members wish to keep their policies going, whether or not we currently offer them to new Members.

Table 11 summarises the Technical Provisions by product category:

Table 11: Technical Provision Components – Group £000										
Business Line	IP		WP		UL		GL		Total	
	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017
BEL	(57,606)	(36,696)	11,163	13,716	915	1,022	-	91	(45,528)	(21,867)
Risk Margin	17,869	11,742	8,497	7,646	-	-	-	-	26,366	19,388
IBNR	-	-	100	83	-	-	-	57	100	140
TP	(39,737)	(24,954)	19,760	21,445	915	1,022	-	148	(19,062)	(2,339)

Key: BEL= Best Estimate of Liabilities, IBNR = Incurred but not reported, TP = Technical Provisions

(a) How are the calculations done? The Best Estimate

1. Income Protection (or IP) Products

We calculate the expected expenses and claims costs for each policy and subtract the expected premiums. The difference between the two numbers is the net cash outflow. We calculate the net cash outflow for each policy, month by month.

The net cash outflow is made up from all the possible things that might happen on a policy. We start by assuming that all Members are healthy at 31 December. Then, for each policy, for every future month, we calculate the net cash outflow in that month:

$$\begin{aligned} \text{Net Cash Outflow} = & \text{expected monthly sickness benefit} \\ & + \\ & \text{expected maturity and withdrawal benefits} \\ & + \\ & \text{expected expenses (to cover investment and administration)} \\ & - \\ & \text{expected premiums} \end{aligned}$$

The calculations include assumptions about the probability that a Member becomes sick, or that their policy lapses or ends for any other reason.

The monthly cash flows are added up and converted to today's value: that is, a lump sum now equivalent to all future cash flows. This value is the Best Estimate for these policies.

To convert the future cash outflows to today's value, we use interest rates provided by EIOPA. All insurers use the same rate. A positive lump sum value is a liability that the Society has to meet, a negative value is an asset. The Society's IP business is written to generate a surplus, so each policy is an asset (i.e. each policy is profitable to the Membership as a whole).

The technical name for this approach is the gross premium valuation. The technique being used to calculate a lump sum is called 'discounting projected monthly net cashflows'. The interest rates are risk-free rates set by EIOPA. A sample of the rates used is set out below:

12: Selected Discount Rates, % As dictated by EIOPA

Duration (year)	1	2	3	4	5	10	15	20	25	30	50
31 Dec 2018	0.981	1.062	1.124	1.170	1.204	1.342	1.429	1.463	1.464	1.453	1.382
31 Dec 2017	0.555	0.684	0.788	0.866	0.937	1.188	1.330	1.378	1.365	1.340	1.166

2. With-profits (or WP) Products

The calculations for WP products are identical to those for IP, except that the different benefits are allowed for. Typically, WP products have some benefits that are guaranteed on maturity or death. We have some discretion over the payment of a final bonus on death or maturity, and on payments on lapse.

Each year, the benefits on these policies are increased by an interest bonus, reflecting investment returns over the year, and an apportionment of surplus, reflecting sickness experience, is added to the benefit payment due.

The probability of these events and the possibility of future increases to the values guaranteed are allowed for in calculating the monthly cash flows. We assume that the interest bonus will be 2% per year and that the final bonuses will remain equal to the rates declared as at 31 December 2018.

3. Unit-linked (or UL) Products

The Best Estimate for these policies is the value of the benefit payable on request. No new premiums are expected on these policies.

4. Group Life (or GL) Products

The Best Estimate for these products is the expected cost of claims arising – that is, the benefit that we expect to pay. These tend to be one-year products, so the Best Estimate is the premiums or part-premium due to be received after 31 December, less the share of commission and expenses. Given that all of these policies had expired by 31 December 2018, the value is zero for 2018.

(b) How are the calculations done? The Risk Margin

The Risk Margin is an amount over and above the Best Estimate equal to the amount that another insurer would need to take on the Society's business.

The regulator sets out how the Risk Margin is to be calculated. The Risk Margin is the cost of holding the SCR, excluding the market risk component, required in every future year, allowing for a required return of interest of 6% per year.

The full formula set down by the regulator can be quite onerous for an insurer as small as we are.

The regulator recognises this and has allowed a simpler formula to be used. We have decided to use 'simplification 1', which estimates the future SCR in proportion to the underlying risk driver of each risk. So for example the amount of capital held in respect of sickness risks is assumed to change in proportion to the expected value of future sickness benefits payable.

The Risk Margin at 31 December 2018 is £29.915m (2017: £19.388m). In Table 11, it has been split between the product types in proportion to future premiums.

(c) Adjustments to the Technical Provisions

We calculate the Technical Provisions for each policy of each product type, assuming that there are no claims being paid from them at the year-end date (31 December). This assumption is unrealistic, so the Technical Provisions have to be adjusted for several real-life situations. The situations are labelled from 5 onwards, because they continue on from the description of the valuation by product type in points 1 to 4 above.

Adjustments

5. Sickness Claims in payment
6. Incurred But Not Reported (IBNR) Claims
7. Allowance for expenses
8. Reinsurance

5. Sickness Claims in payment

When a claim is being paid to a Member on a policy at 31 December, an additional process is followed to adjust the Best Estimate. For these policies, we calculate the amount we expect to pay our Member every month until the Member returns to work, the policy ends, or it reaches the maximum payment allowed, or the Member reaches retirement.

6. Incurred But Not Reported (IBNR) Claims

We recognise that some Members may be sick but have not yet had time to inform us, or have told us that they are sick but we have not yet confirmed that we can pay a benefit. Similarly, for Optimal, an employee may have died but the company sponsoring the scheme has not yet had time to tell us.

We ring fence capital to cover the likely Member benefit. How do we decide how much capital is needed? For the Society, we calculate the average of annual sickness claims over the last three years and divide by 12 to give a monthly amount (we are assuming that all claims will be known about within one month). For Optimal, we have assumed that this is zero. The insurance jargon for the claims covered by this capital is 'Incurred-But-Not-Reported' Claims, or IBNR Claims.

7. Allowance for expenses

We meet the Society's running expenses, including ensuring that its assets are properly invested. In determining the Best Estimate, we assume that each policy bears an equal share of the total expenses for every month and that the total expenses are covered in full. In these calculations, we expect new policies to bear their share of future expenses, and we allow for policies that end, whatever the reason. We plan new business over three years from the 31 December at which the calculations are done. After this point, expenses are increased in line with an expense inflation assumption.

8. Reinsurance

We have four reinsurance arrangements in place. Three of these cover policies providing an income when a Member is sick and one covers policies providing a payment to Members' estate on death.

Company	Description of Reinsurance Arrangement
Hannover Re	covering the Premier Plan, paying 50% of the sickness benefit and 100% of the waiver of premium benefit paid after at least 13 weeks of sickness.
GenRe	covering the PIP product, paying 50% of the sickness benefit paid. covering the CI-IP and EIIP products, paying 50% of the sickness benefit paid.
Swiss Re	covering PRFS death benefit, paying 100% of all death claims.

None of these arrangements are material because they cover only a small number of policies and the chance of a payment being triggered is very low. They have all been ignored in the valuation.

(d) Assumptions

The calculations need a number of things to be assumed, specifically:

- A1. if and when Members might fall sick and how quickly they might recover
- A2. if and when Members might stop their policies
- A3. how much it will cost to run the Society and implement its strategy
- A4. how expenses and benefits will grow with inflation, and
- A5. If and when policies might end because of death.

A1. if and when Members might fall sick and how quickly they might recover

We investigate our sickness experience every year, although there are relatively few cases. We look at how many Members become sick and how long it takes them to recover. The low number of cases means that it is harder to use the experience to decide on an assumption. We therefore consult industry data which suggests rates of sickness and recovery. The tables we use are called CMIR12.

Table 13: Assumed Sickness Rates

Assumption	31 Dec 2018	31 Dec 2017
Inception Rate ¹	30%	30%
Recovery rates²		
0-4 weeks	60%	60%
4-13 weeks	115%	125%
13-26 weeks	175%	200%
26-52 weeks	250%	
52+ weeks	150%	

¹of DP1, Part C, section 9.1 CMIR12 (inceptions)

²of graduated recovery rates, Table B6(a) CMIR12 (recovery basis)

A2. if and when Members might stop their policies

If a Member stops their policy, the policy is said to have lapsed. The lapse rate is the proportion of policies that lapse during a given period. The assumed rates of lapse and withdrawal used for the valuation are set out in the following table.

There was an arrangement with GenRe to cover the Optimal business (paying 90% of claims up to £50,000, 100% thereafter), but all policies subject to this arrangement have now concluded.

Table 14: Assumptions: Lapse Rates, % pa

Product	31 Dec 2018	31 Dec 2017
Holloway & Purely		
Year 1-2	10%	7.5%
Year 3		
Year 4	11%	
Year 5	10%	
Year 6-15	9%	
Year 16+	4%	
Commuted IP	2.5%	2.5%
Short Term IP		
Year 1	20%	20%
Year 2	17.5%	17.5%
Year 3	15%	15%
Year 4	12.5%	12.5%
Year 5+	10%	10%
one2Protect		
Year 1	10%	n/a
Year 2	9%	
Year 3	8%	
Year 4	7%	
Year 5-9	5%	
Year 10+	3%	

A3. how much it will cost to run the Society and implement its strategy

In the valuation, we work out the expense that we expect to incur in the three years from 1 January 2019, based on the activities we expect to carry out.

A4. how expenses and benefits will grow with inflation

We assume that expenses increase each year. Some products have benefits that increase with inflation. We make assumptions about these different types of inflation as set out below:

Table 15: Assumptions: Expense Inflation Rate, % pa

Assumption	31 Dec 2018	31 Dec 2017
Expense Inflation	3.25%	3.10%
RPI Inflation	3.40%	3.30%

The type of expense is important. Some expenses are expected to occur every year (for example, the expense of people to look after Member queries). Some expenses are linked to sales and only happen once in a policy lifetime. Others are one-off, such as the investment in the new administration system. The projections that we use take into account the different type of expenses and the different types of activity. In this way, we try to make sure that our projections are a good approximation to the actual business activity expected.

A5. if and when policies might end because of death

We use industry tables to assess if and when policies might end due to death, although the impact on the Best Estimate is very small.

We assume 50% AMC00 except for policies where a claim is being paid, when we assume 100% CMIR12 mortality rates. AMC00 is a standard mortality table.

(e) Some Technical Points that we are required to mention

Differences between Solvency Valuation and Financial Statement Valuation

We use the same bases, methods and main assumptions to value liabilities for solvency purposes as we use in our financial statements.

Currency

Our liabilities are all recorded in Great British Pounds, sometimes shortened to GBP.

Options and guarantees

None of our policies has any options which are financially significant or any guaranteed surrender values.

Uncertainty associated with the value of Technical Provisions

Calculating Technical Provisions involves predicting the future. The early values are better known than the later values. Later values are determined using assumptions, which may not work out in practice.

The uncertainties include economic uncertainty (what will interest rates be?), Member behaviour (when might Members make withdrawals from their policies) and fate (when might a Member fall sick?). In practice, the uncertainties might increase or reduce the cash flows, and hence increase or reduce the Best Estimate.

We are particularly sensitive to:

- Expense Assumptions, given the scale of the change that the Society is undergoing
- Sickness Assumptions, given the lack of data to support the assumption setting, and
- Lapse Assumptions, given the lack of data to support the assumption setting and the sensitivity of lapse rates to changes in regulation and general economic health.

Differences with the financial statements

There are no differences, material or otherwise, between the way in which the Technical Provisions are calculated and the calculations that underpin the financial statements.

What are the financial statements?

Financial statements are the reports that we are required to produce by law. They are available on our website or on request. They are sometimes referred to as the Report and Accounts. They include a balance sheet and profit and loss account.

Use of Transitional Measures

The regulator allows insurers to use 'transitional measures' or a 'volatility adjustment' if they need to. We do not need to, but we have to state this in this document. The Society has not used transitional measures or the volatility adjustment.

D.3 Other liabilities

The Society's reported liabilities are the Fund for Future Appropriations, Technical Provisions for linked liabilities and Creditors. Table 16 provides more details of the Society's creditors.

Table 16: Society creditors at 31 December £000

Liability Type	31 Dec 2018	31 Dec 2017
Arising out of direct insurance operations	-	108
Arising out of reinsurance operations	7	98
Claims outstanding	169	112
Other creditors including tax and social security	2,113	1,763
Total	2,289	2,081

There is no observable market for these specific liabilities or any similar liabilities that could be regarded as a suitable basis for the valuation. The value is therefore based on an estimate of the expected cash flows, i.e. the settlement value. No account has been taken of the effect of discounting short-dated payables as the effect is deemed to be immaterial.

We have some obligations that we have to meet within the next 12 months. Their value has been calculated in accordance with the principles used in our Report and Accounts. The full Report and Accounts document, which includes our accounting policies, is available on our website, www.holloway.co.uk.

D.4 Alternative methods for valuation

We value our property by asking an external and independent professional property consultant, who offers a property valuation service, to provide us with a value. The valuer looks at other, similar properties and considers their price (where they have recently been sold) and their rental value.

We value our corporate and other bonds using prices from a single broker. The prices are thus from an external source.

We don't use any other alternative methods for valuation.

D.5 Any other information

Nothing additional to report.

E. Capital management

E.1 Own funds

We are governed by the Friendly Societies Act 1992. Under that Act, the Society is an incorporated society with a single Members' fund and no defined mutual member fund. As such, it has no shareholders and our Members are the ultimate owners of the business. The Society's organisation is very simple: all its capital is held in tangible and realisable assets.

What are Own Funds?

This is jargon for an insurer's total assets, counted using the rules of Solvency II.

The table below, a copy of Table 1, shows the Own Funds and Surplus Capital:

Table 1: Own Funds, £000		
Item	31 Dec 2018	31 Dec 2017
Own Funds	57,461	50,704
Solvency Capital Requirement	(36,876)	(27,825)
Surplus Capital	20,585	22,879

Own Funds, used in this report, can be linked back to the Fund for Future Appropriations, again by removing the intangible assets and prepayments.

Table 17: Reconciliation of the Society Fund for future appropriations to Own Funds, £000		
	31 Dec 2018	31 Dec 2017
Fund for future appropriations	58,986	51,290
Intangible assets: policy administration system	(1,359)	(270)
Intangible assets: product and software development	(71)	(210)
Prepayments	(96)	(106)
Own Funds	57,460	50,704

31 Dec 2018 column does not add up exactly, due to rounding

Own Funds – Objectives, Policies and Processes

Own Funds – Objectives

We manage our Own Funds according to our investment policy. Broadly, this requires us to invest to ensure we can pay all Member benefits as they fall due, to invest in ways that treat Members fairly and meet their expectations, to invest to meet all solvency requirements and, having met these criteria, to invest to maximise returns, subject to a level of acceptable volatility.

The strategy builds on the investment policy by recognising that the best return is achieved by investing in new business.

Given the strategy, we aim to invest to meet the Society's requirements for cash over the business plan period (1 January 2017 – 31 December 2021), bearing in mind the premiums we expect to receive, the claims that we expect and the new policies that we expect to go on risk.

We aim to generate a return on the assets held. We aim to be always able to meet the benefits due to Members.

Own Funds – Policies

Investment Policy: From time to time, the Board agrees the Society's investment policy. This describes the powers and limits of authority of the Society's selected investment managers. The Investment Committee makes sure that the Investment Policy is followed.

ORSA Policy: The regulator requires us to produce a policy setting out how we will run our ORSA. At least once a year, we run our ORSA process (see Section B.3). Part of this process is to allow the Board to assess the level of future Surplus Capital expected allowing for all sorts of different risks over time. The Board wants to be sure that it always has enough capital to pay policyholder benefits, and that it knows which risks could threaten this position.

The ORSA process includes testing of many different risks. It allows the Board to understand where there might be a problem and to draw up plans to deal with it. The plans will depend on the situation, but might include a change of strategy, re-pricing or re-designing our products, or changing how we organise the business (usually so it runs at a lower cost). More dramatic action includes closing to new business or transferring the business to another organisation.

Knowing the split of Own Funds between surplus capital and assets backing the SCR over the business plan period allows the Society to consider if a different investment approach is better suited to protecting Member benefits.

Own Funds – Processes

At least twice every year, the Society reviews the performance of its investment managers to ensure that the investment policy is being followed and to assess performance.

Material Changes

In 2018, the Society consolidated its equity and fixed interest with a single firm, LGT Vestra. There have been no changes to the investment policy or the objectives, policies or processes used in investing the Own Funds during 2018.

Capital Tiers

The regulations classify capital in different tiers. All of the Society's Own Funds are Tier 1 (the highest quality tier of capital) and have always been Tier 1.

At 31 December 2018, our Tier 1 capital was £57.460m (2017: £50.704m). There are no restrictions on how we might use our Own Funds. They are fully available to cover the SCR and the MCR.

What is the MCR?

The MCR, or Minimum Capital Requirement, is the threshold at which the regulator is allowed to take over the running of an insurer. It is much lower than the SCR (about a quarter of the amount).

The level of Own Funds and of Surplus Assets has changed over the reporting period reflecting the progress of the strategy and the investment in new business.

Required Statements

The regulations require us to set out a number of points about our Own Funds. Specifically:

- The material differences between the equity in the Society's financial statements and the free capital for solvency purposes are shown in Table 19.
- There are no Own Fund items subject to a transitional arrangement
- Under the rules, insurers are allowed to hold Ancillary Own Funds. Ancillary Own Funds count as capital, but are slightly less easy to get hold of. We don't have any Ancillary Own Funds.

- There are no deductions from our Own Funds and no restrictions on their availability and transferability.

E.2 Solvency Capital Requirement and Minimum Capital Requirement

The following table summarises the Society's SCR and MCR.

Table 18: Solvency and Minimum Capital Requirement, £000		
	31 Dec 2018	31 Dec 2017
Market risk	9,925	10,498
Counterparty default risk	522	809
Life underwriting risk	-	4
Health underwriting risk	32,674	22,694
Diversification across all risks	(6,520)	(6,465)
Basic Solvency Capital Requirement	36,601	27,540
Operational risk	275	285
Solvency Capital Requirement	36,876	27,825
Minimum Capital Requirement	9,219	6,956

We are allowed to take credit for any action that we might take to improve our capital position. We have decided not to use this option at the moment.

We are satisfied with the result of the calculations to give the SCR and MCR. The regulator reserves the right to assess the result and ask us to amend it. If this happens, we will amend this document and describe the changes.

Required Statements

The regulations insist that we set out a number of points about our SCR and MCR. Specifically:

- There are no simplifications applied to the SCR calculation.
- There are no undertaking-specific parameters used in the SCR calculation
- The MCR for the Society is 25% of the calculated SCR.

The MCR is calculated using a regulator-provided formula. It varies between 25% and 40% of the SCR. The parameters used in its calculation include the size of the technical provisions and the capital at risk on death/disability. 25% of the SCR is the minimum, subject to a minimum of £3.125m.

There has been no material change to the SCR or the MCR in the reporting period.

E.3 Duration-based equity risk sub-module in the calculation of the SCR

The regulations allow the SCR to be calculated using something called the duration-based equity risk sub-module. We don't use this, and have to state that this is the case.

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

We calculate our SCR using the standard formula, as set out by the regulator.

Insurers are allowed to use an internal model, which is an approach that is tailored to the individual insurer. We judge that using such a model would not produce a better result for the Society and would be much more expensive than the approach we have taken, so we don't use an internal model.

The regulations require us to describe the differences between the standard formula and the internal model, but that does not apply to us.

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

We complied with the rules regarding the maintenance of the SCR and the MCR continuously throughout 2018.

E.6 Any other information

Nothing additional to report.

Summary of Explanatory Notes

The notes are not intended to be definitions, nor are they very technical. They have been provided to aid understanding. If you would like a technical definition or to understand more about the limits of the explanation, we would be happy to provide more details.

Term	Explanatory Note
Actuary	An actuary is a specialist insurance mathematician who is trained in actuarial work. Actuarial work tends to involve projecting events over the long term. Events include sickness, investment returns and expenses. Actuaries use these projections to confirm the financial health of insurers.
Assets	Accountants talk about assets and liabilities. The accumulated premiums less outgoings are labelled as assets. We use the proceeds of the assets to meet the liabilities.
Audit and Risk Committee	The Board has set up Committees to help it with some of the oversight work that it does. The Audit and Risk Committee oversees internal and independent audit, compliance, actuarial and risk management activities. It ensures that the risk management and internal control systems are effective. Details of its terms of reference (the rules it follows) are on our website.
Board	Most companies are run by a Board of Directors. These are the people who direct the company, decide its strategy and ensure its governance. The Board oversees plans, performance and activity and, if not satisfied, makes changes. The Board is chosen by the owners of the company. For us, the Board is chosen by you, our Members.
Capital	Capital is the regulatory name for the resources available to meet the Society's outgoings. For the Society, capital is made up of cash, investments and the difference between expected premiums less current and future claims and expenses
Chair	The Chair is the Non-Executive Director who leads the Board. It is an important role with specific responsibilities to the regulator and to Members.
Executive	The Executive refers to the Chief Executive, the Sales & Marketing Director and the Chief Financial Officer. These are the employees who run the Society, led by the Chief Executive, responsible to the Board.
Experience	Insurers make a lot of assumptions in their planning and projections. Experience is the term used to describe what actually happened rather than the assumption that was made.
Independent auditor	An independent auditor is a firm appointed mainly to provide independent assurance to Members that a Society's accounts are broadly accurate.
Financial statements	Financial statements are the reports that we are required to produce by law. They are available on our website or on request. They are sometimes referred to as the Report and Accounts. They include a balance sheet and profit and loss account.
Governance	Governance covers everything to do with being sure that a business is running properly. It includes legal requirements, the need to be fair to Members, and the need to organise the business sensibly and with due regard for risk.
Holloway product	We understand that we were the first organisation to combine income protection and savings. The resulting innovative product, introduced in the 1880s, was named after our founder, George Holloway.
Lapse	When a member decides not to continue with their policy, we say that the policy has 'lapsed'. Policies may also end because the Member dies, the Member reaches retirement or the policy reaches its maturity date.

Summary of Explanatory Notes

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Term	Explanatory Note
Liabilities	Accountants talk about assets and liabilities. For the Society, our policies are labelled as liabilities. They are the commitments we have to meet.
Liquidity	Liquidity is the term used to describe how easy it is to get hold of cash when it is needed. Liquidity changes when the economy changes: for example, when property is hard to sell, it is illiquid.
Liquidity risk	Liquidity risk for us occurs when a benefit cannot be paid because we cannot physically get hold of the cash to pay. We take steps to make sure that this can never happen, as far as we can tell.
MCR	The MCR, or Minimum Capital Requirement, is the threshold at which the regulator is allowed to take over the running of an insurer. It is much lower than the SCR (about a quarter of the amount).
Operational risk	Operational risk is the risk of some planned activity going wrong because a process fails, a system fails or someone does something wrong. Operational risk includes errors caused by processes, systems or people not doing something, as well as doing something wrong. For insurers, the regulator suggests that fraud and legal problems are included as operational risks.
ORSA	The regulation requires insurers to undertake an Own Risk and Solvency Assessment, or ORSA, whenever its risks change, or at least annually. The ORSA is a judgement by the Board of the insurer's risks and the impact on the insurer's solvency. Importantly, it is the Board's view, not the regulator's (and not the view using the regulatory formula).
Own funds	This is jargon for an insurer's total assets, counted using the rules of Solvency II.
Prudent Person Principle	This is a phrase in the regulations. It means that investments should be only those that a prudent person would make.
Reinsurance	Reinsurance is insurance for insurance companies. An insurer can use reinsurance to reduce its own risk, to provide technical support and to help with cash flow. Reinsurance is provided by specialist firms called reinsurers. The insurer pays a premium to the reinsurer. In return, it receives money from the reinsurer for claims that are made. Insurers are always responsible to their policyholders for the risk that they take on. Reinsurance might offer security for insurers, especially when the products being sold are new. This explains why we have very little reinsurance for our income protection business (which we have been selling for many years), but we did have reinsurance for our Optimal business, which was much younger.
Risk register	The Society's risk register is a list of the risks that we face with details of how the risks are identified, measured, monitored, managed and reported.
Risk tolerance	Most measures of performance have an expected value or target. The risk is that the actual value is higher or lower than the target, to an extent that might cause harm or cause the plan to be re-considered. A risk threshold is, for a given measure, the value at which action is needed to prevent harm or to reconsider the plan.

Summary of Explanatory Notes

The notes are not intended to be definitions, nor are they very technical. They have been provided to aid understanding. If you would like a technical definition or to understand more about the limits of the explanation, we would be happy to provide more details.

Term	Explanatory Note
Senior Leadership Team	This is the group of people who work for members of the Executive. On a day-to-day basis, the Senior Leadership Team makes sure that the Society is properly run. Members of this team attend the monthly Executive, and some other Committee meetings and, depending on their job, may occasionally attend or present at Board meetings.
Solvency	<p>When a risk event happens, often (but not always) the simplest solution is money. Regulators recognise that the more surplus money a firm has, the more secure the policyholder benefit. 'Solvency' is the jargon used by insurers to mean the capital that a firm has in excess of that needed to meet Member claims in most circumstances.</p> <p>Insurers talk about capital rather than money.</p> <p>When considering a risk, insurers look at the impact the risk might have on their surplus capital: hence, the impact on solvency.</p> <p>Generally, high or increasing solvency is a good thing, low or declining solvency is a concern, unless the change was planned or there is a good reason for it.</p>
Solvency II	<p>Solvency II is the name given to the European regulation that UK insurers have to follow. It sets out what insurers have to do to protect policyholder benefits.</p> <p>The areas discussed in this document are all required under Solvency II, as is the production of this document.</p>
Solvency Capital Requirement	<p>This is the amount that the regulator says the Society has to hold to ensure policyholder benefits are secure in most circumstances over one year. It is calculated using a formula provided by the regulator. It is often shortened to SCR.</p> <p>The size of the SCR depends on the cost of the risk in the business. Is a high cost of risk a bad thing? Only if you do not have enough capital to meet the cost of risk.</p> <p>A higher cost of risk means a bigger SCR. If a firm can meet its cost of risk, any surplus capital provides extra security for Members or can be used for other purposes.</p>
Surplus capital	Surplus capital is the capital over and above that needed to meet expected Member benefits.
System of governance	For the Society, this means everything that is in place to make sure that the Society is well governed.
Underwriting	Underwriting is the process of assessing someone's health and lifestyle to decide the best protection that we can offer and the cost and conditions of this protection.
Valuation	Every year, we are required to calculate the value of the policies that we administer, primarily to make sure that we have enough capital to meet the benefits that are due to Members. This process is called the valuation.

