Annual Report to With-Profits Policyholders for 2018

1 Summary

The Society has reviewed the management of its with-profits funds. The Society believes that it has complied with its obligations relating to its Principles and Practices of Financial Management.

The following sections provide the background and reasons for the Society having reached this opinion.

2 Introduction

The Principles and Practices of Financial Management (the PPFM) sets out the way that the Foresters Friendly Society (the Society) manages its with-profits business.

The Financial Conduct Authority rules require insurers to provide an annual report to with-profits policyholders on whether the Society believes it has complied with its obligations in relation to its Principles and Practices of Financial Management. In addition the report should describe how the Society has exercised discretion and the way that the Society has addressed matters such as the respective interests of its policyholders.

The Society maintains a number of with-profits funds (which may also include non-profit policies), namely "the Order Insurance Fund", "the Pure Endowment Fund", "the Tunstall Fund", the "Leek Fund" and the "POIS Fund". The Tunstall Fund, the Leek Fund and the POIS Fund were set up as a result of transfers of engagements to the Society on 31st December 2003, the 31st December 2005 and the 26th September 2014 of the Tunstall Assurance Friendly Society Limited, the Leek Assurance Collecting Society and the Post Office Insurance Society business from Family Assurance respectively. Each with-profits fund is ring-fenced with each fund having its own separate portfolio of assets.

3 Governance Arrangements

The Board has responsibility for compliance with the Society's PPFM. The Society has set up a With-Profits Advisory Arrangement for each fund, which is made up of non-executive directors. Details of the members are shown in the Society's Annual Report and Accounts. The role of the With-Profits Advisory Arrangements is to exercise independent judgement in assessing compliance with the Society's Principles and Practices of Financial Management and in addressing conflicting rights and interests of policyholders within the with-profits funds. The Board and the With-Profits Advisory Arrangements are advised by the With-Profits Actuary.

The With-Profits Actuary provides advice to the Board on the exercise of discretion with regard to with-profits contracts, including on key aspects of the application of the Society's PPFM. The With-Profits Actuary's report to policyholders in respect of 2018 is contained in the Appendix to this report.

4 Compliance with the obligations of the PPFM including the exercise of discretion

4.1 Investment Policy

Investment performance is considered quarterly by the Board's Investment Committee. The Society monitors the actual assets held against the target ranges in the PPFM on a monthly basis.

During 2018 asset classes were generally within the target ranges for the with-profits funds except for the Pure Endowment and the POIS Ring-Fenced funds. The Pure Endowment was a continuation from the previous year where the maturities were paid out from the cash holdings without the need to disinvest any short dated fixed interest holdings in order to maximise the fund's investment return. The POIS Ring-Fenced fund was overweight in equities for the first two months, then was marginally overweight in corporate bonds for the remainder of the year. The allocations in these asset classes were close to the perimeters of the target ranges and therefore price movements meant allocations moved outside the ranges from time to time.

4.2 Bonus Rates

This is the main area of discretion in managing the Society's with-profits business. Section 2 of the POIS PPFM and sections B4, B5, C5 and C6 of the PPFM for the remaining funds describe how the Society exercises its discretion in setting bonus rates.

In February 2018, annual bonus rates were reviewed and the rates declared were unchanged from the previous year.

Revised final bonus rates for the Order Insurance Fund were adopted with effect from 1 July 2017, whereas those for the Pure Endowment Fund, the POIS Fund and the Tunstall Fund were adopted with effect from 14 August 2017. In deciding on the revised bonus rates the Board considered the advice of both the With-Profits Advisory Arrangements and the With-Profits Actuary.

The Society believes that the bonus rates were consistent with the PPFM.

A review of the Leek Fund was carried out which concluded that the fund continues to be unable to afford to pay bonuses.

4.3 Payouts

Maturity values are the amounts payable upon reaching the end of the term of the policy.

Surrender values, where applicable, are the amounts payable upon cancellation of a policy before it would otherwise be payable upon death or maturity. The calculation of surrender values was reviewed and updated as part of the review of final bonus rates.

For some products the Society has the right to apply a Market Value Reduction to reduce the amount paid on surrender to an amount that fairly reflects a policy's value. During 2018 there was no need for the Society to impose Market Value Reductions.

A review of the Society's with-profits funds' payout ratios during 2018 indicated that a number of instances have meant that fewer than 90% of the payouts were within the PPFM target range of 70% to 130% of the asset share. These instances relate to:

- maturity payouts for the Pure Endowment Fund and POIS fund; and
- surrenders payouts for the Order Insurance Fund, Pure Endowment Fund and POIS fund.

The Society investigated the reasons for this outcome.

For maturities:

- Pure Endowment Fund: 82% of payouts were within the target range. Payouts outside the target range were higher than asset share and mostly related to small policies as 96% of payouts measured by amount were within the target range. Small policies can have payouts outside the target range due to terminal bonuses being calculated at product rather than policy level. This is in line with the PPFM.
- POIS fund: 80% of payouts were within the target range and most outside the target range were paid more than asset share. Payouts outside the range were primarily due to: payouts being higher than asset share due to small premiums paid but terminal bonuses being set at a product level, and smoothing down of higher previous year payouts leading to an overpayment against asset shares. This is in line with the PPFM.

For surrenders:

- Order Insurance Fund: 85% of payouts were within the target range and most outside the target range were paid more than asset share. Payouts outside the range were due to: whole life policies where the future cost of providing death benefits targets asset share and not payouts over the next year, and where surrender benefits are return of premium invested leading to a difference to asset shares.
- Pure Endowment Fund: 83% of payouts were within the target range. This was due to one small policy slightly below the target range. The treatment of small policies is consistent with the PPFM.
- POIS fund: 74% of payouts were within the target range, with 16% above the target range and 10% below the target range. This was due to: the fund being limited by one terminal bonus scale applying to both endowments and whole life business, treatment of small policies, smoothing of year-on-year changes in payouts. The Society is developing a new policy administration system which may provide greater flexibility to set terminal bonus rates differently between endowments and whole life product types.

Despite not meeting all of the target range requirements, the Society is satisfied it has exercised discretion during 2018 in a manner that takes with-profits members' interests into account.

4.4 Management of the Inherited Estate

The Inherited Estate is defined in the Glossary of the POIS PPFM and Paragraph B10.1 of the PPFM for the remaining funds as:-

"The excess of assets maintained within a with-profits fund over and above the amount required to meet liabilities (including liabilities which arise from the regulatory duty to treat customers fairly in setting discretionary benefits)"

For the Pure Endowment Fund, special bonuses were declared at incorporation to reflect the differing financial positions and past practices of the Districts, so as to ensure equitable treatment for the former members of each district.

For the Pure Endowment, Tunstall, Leek and POIS Funds, the method of determining policy payouts aims to ensure that any surplus is extinguished as the portfolio of business declines. The inherited estate for these funds can therefore be considered to be negligible.

For the Order Insurance Fund, being the with-profits fund open to new business, the inherited estate continues to provide working capital to support new business risks within the fund. Miscellaneous profits and losses are absorbed by the inherited estate, to be allocated to with-profits policies in the future, depending on the size of the estate and risk profile of the fund.

4.5 Charges

During 2018 the Board has continued to limit the effective charge to with-profits policies in the Order Insurance Fund and the Pure Endowment Fund to less than the actual expenses incurred, with the difference borne by the Group Capital Fund. For the Tunstall Fund, the Leek Fund and the POIS Fund the charges for expenses have been in accordance with the transfer agreements, updated in accordance with those agreements, and in addition, the Society has agreed a subsidy to further limit the expenses charged to the Leek Fund.

4.6 New Business

The Pure Endowment Fund, the Tunstall Fund, the Leek Fund and the POIS Fund are all closed to new business. The Order Insurance Fund is the only with-profits fund that is open to new business. The profitability of the new business being written is considered on a regular basis. As part of the annual planning process, the Board remain satisfied that it is in the interests of the with-profits policyholders for the Society to remain open to new business.

The Board has recognised that the prevailing investment conditions has reduced product profitability. During 2018, the Society:

- reviewed and launched repriced versions of the ISA, Bond, 50+ and Tax Exempt Savings Plan products to improve profitability; and
- closed the Guaranteed Savings Plan product to new business.

4.7 Managing Competing or Conflicting Rights of Policyholders

The Society is a mutual organisation and therefore avoids any competing or conflicting rights between policyholders and shareholders. However, different groups of policyholders have potentially competing interests due to:

- different types of products;
- policies of different sizes or policy terms;
- policies with different start and end dates; and
- different with-profits funds.

An important consideration in ensuring that the interests of different groups are balanced is the way that policies are grouped together. Policies are grouped together into distinct classes within each fund, taking the following criteria into account;

- taxable or tax-exempt policy status;
- endowment, whole life or pensions;
- regular or single premium paying status; and
- conventional or accumulating with-profits product type.

Different bonus rates are declared for distinct classes of with-profits business.

When setting bonus rates the Society aims to limit the size of the change in payouts on policies of a similar type to no more than 10% from year to year.

The approach taken during 2018 was consistent with the PPFM.

4.8 Changes to the PPFM

The PPFMs were reviewed in 2018 and updates were made and publicised on the Society's website. The following changes are effective from 30 June 2018:

- POIS target range for maturities and surrenders have been changed to 70%-130%. As mentioned in the 2017 annual report, payouts will not be affected and this is a more appropriate range for new payout methodology which was introduced post the transfer of the business to Foresters.
- For policies written since February 2018, deductions from asset share may include an annual charge to cover the capital and guarantee costs. Currently this annual charge is up to 1% of asset share. The size of these charges may vary from time to time based on the expected cost of the guarantee and the level and cost of the regulatory capital required to manage the policy.

The Society's PPFMs provide definitions of the terms used within this paper. The PPFMs are available on our website. If you would like a copy of the PPFM, please contact our Member Services team on 0800 988 2418 during our normal office hours.

Appendix: Report of the With-Profits Actuary to With-Profits policyholders of The Ancient Order of Foresters Friendly Society Limited

I have been appointed by The Ancient Order of Foresters Friendly Society Limited (the Society) to act as With-Profits Actuary. I was appointed to this role by the Society in November 2017. I am a Fellow of the Institute and Faculty of Actuaries and a Partner of Barnett Waddingham Limited. I am not a policyholder of the Society.

The Society must produce an annual report to its with-profits policyholders that states whether it believes it has complied with its obligations relating to Principles and Practices of Financial Management (PPFM) and setting out its reasons for that belief. As the Society's With-Profits Actuary, I am required by Financial Conduct Authority (FCA) rules to report to with-profits policyholders on whether the Society has exercised discretion in a reasonable and proportionate manner. The purpose of this report is to report to with-profits policyholders on the exercise of discretion in 2018.

I can confirm that, during 2018, I have been informed and consulted on all material matters relating to the transaction of with-profits business. I have also requested from the Society such information and explanations as I consider reasonably necessary to enable me to perform my duties as the With-Profits Actuary. In preparing this report, I have taken into account, where relevant, the rules and guidance issued by the FCA and the Prudential Regulation Authority (PRA).

Over 2018 there have been some breaches in relation to the Society's target investment ranges set out in its PPFM, these have either been temporary or not material. There is one exception relating to a breach for the PEF, which is due to a deliberate decision by the Society in order to maximise investment income. I am satisfied with the explanation provided to me and consider it fair to PEF with-profit policyholders.

Over 2018 there have been a number of breaches in relation to the Society's target payout ranges set out in its PPFM. I am satisfied that the causes of these breaches are consistent with other requirements in the PPFM and have made recommendations to the Society that these should be reviewed, or, in the case of breaches for the Post Office Insurance Society (POIS) Fund, are being addressed by a system upgrade, to allow greater flexibility in setting terminal bonus rates.

Overall, I am satisfied that the discretion exercised by the Society in 2018 may be regarded as having taken the interests of the Society's with-profits policyholders into account in a reasonable and proportionate manner.

This report is provided for the purposes set out above, and should not be used as the basis to make any decisions regarding contracts with the Society, whether to enter into them, to continue them or terminate them, for which decisions fuller information and qualified financial advice should be sought.

Kim Durniat FIA
With-Profits Actuary

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