Solvency and Financial Condition Report 2016 – Metfriendly

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Abbreviations used in this Report

AFH	Actuarial Function Holder
AWP	Accumulating With-Profits
A&C	Audit and Compliance [Committee]
BEL	Best Estimate Liabilities
CA	Chief Actuary
CEO	Chief Executive Officer [of Metfriendly]
CFO	Chief Finance Officer
CNP	Conventional Non Profit
CMI	Continuous Mortality Investigation
CWP	Conventional With-Profits
DTA	Deferred Tax Assets
FCA	Financial Conduct Authority
FLAOR	Forward Looking Assessment of Own Risks
HRG	Homogeneous Risk Group
IBNR	Incurred But Not Reported
ICOP	In Course of Payment
INSPRU	Prudential Sourcebook for Insurers (contains the regulations under Solvency I)
LOB	Line of Business
MCR	Minimum Capital Requirement
Metfriendly	Metropolitan Police Friendly Society Ltd
NED	Non-Executive Director
ORSA	Own Risk and Solvency Assessment
PPFM	Principles and Practices of Financial Management
PRA	Prudential Regulation Authority
PV	Present Value
R&A	Report and Accounts
R&I	Risk and Investment [Committee]
RM	Risk Margin
RSR	Regulatory Supervisory Report
RST	Reverse Stress Test
QMI	Quarterly Management Information
SCR	Solvency Capital Requirement
SFCR	Solvency and Financial Condition Report
SIMF	Senior Insurance Management Function
TAS	Technical Actuarial Standard
TP	Technical Provisions
WPA	With-Profits Actuary
WPNED	With-Profits NED (the Advisory Arrangement adopted by Metfriendly)

SUMMARY

1. Background

Metropolitan Police Friendly Society Limited (also referred to as 'Metfriendly' or 'the Society' in this document) is a mutual organisation, owned by its members, and established as a friendly society.

It is regulated by the Prudential Regulation Authority and the Financial Conduct Authority. The Society is not part of a group of companies and has no subsidiaries.

Whilst all serving and former members of the police services are eligible to join the Society, sales and marketing activities are focussed on those in the London area - reflecting the organisation's close links with police services in the capital.

As at 31 December 2016, Metfriendly had 12,619 members and assets of approximately £140m.

2. Business Review

The Society had a successful year in 2016, generating gross premium income of over £24m. This included over £17m of single premium (mainly ISA) new business, invested into the With-Profits Fund. In 2016 the assets backing this fund achieved a gross return of 11.7%, reflecting strong growth in equity markets in the second half of the year. Operating expenses rose in line with expectations during the year from £2.1m to £2.4m as staffing was strengthened and the Society invested more in sales and marketing activities.

Following a review of the Society's capital strength as at 31 December 2015, an allocation of £1m of capital was made to with-profit contracts during the year, increasing asset shares which will produce higher future payouts on the affected contracts. The Society's capital coverage remains strong, at 327% of its Solvency Capital Requirement as at 31 December 2016.

3. System of Governance

The Society's Board of Management ('the Board') is responsible for oversight of the organisation and setting its strategy. The Board is supported by 5 Board committees.

The Society has a clear reporting structure and requires all personnel responsible for the organisation's oversight and key functions to have the requisite skills and experience to fulfil their roles and responsibilities. It has robust procedures for ensuring their fitness and propriety on appointment and whilst in office.

The governance structure supports the Society's approach to risk management by ensuring that risks are managed prudently and in line with the organisation's conservative risk appetite. This is based on ensuring that capital strength should not be compromised, but that this should be balanced against the requirement to achieve good investment returns for members and to avoid holding excessive levels of capital.

Risk management is overseen by the Board, with detailed review carried out on its behalf by the Risk and Investment Committee which regularly reviews the Society's risk register. This Committee also oversees the annual Own Risk and Solvency Assessment (ORSA) process that takes place throughout the year, ensuring that it is fully integrated with the decision-making process.

The Society's actuarial function is outsourced to Milliman LLP, with oversight of this arrangement provided by the Society's Chief Executive Officer who is a qualified actuary.

4. Risk Profile

The Society uses the Standard Formula to calculate its Solvency Capital Requirement (SCR) under the Solvency II regime, as this represents an appropriate capital for an organisation with the Society's risks. The most material financial risk faced by the Society is market risk. The Society does not avoid market risk, recognising that it needs to generate acceptable returns for members. However, it does seek to mitigate it by holding a well-diversified investment portfolio.

The Society also considers reputational risk to be significant. It therefore adopts a highly risk averse approach to safeguarding policyholder data.

5. Valuation for Solvency Purposes Summary

The Society's principal assets as determined for solvency purposes grew during 2016 and amounted to £138.4m as at 31 December 2016, increased from £118.4m as at Day 1 (1 January 2016) Solvency II ('SII').

Its liabilities comprise primarily of technical reserves for benefits and guarantees accrued to members, being the sum of the best estimate of liabilities and the risk margin. The total liabilities have increased in line with the new business written during 2016 and amounted to £111.5m as at 31 December 2016, increased from £92.2m as at Day 1 SII.

6. Capital Management Summary

The Society's Solvency Capital Ratio as at 31 December 2016 was 327% with own funds of £27.2m and a Solvency Capital Requirement ('SCR') of £8.3m. This level of coverage is within the Board's risk appetite which is to maintain coverage within a target range which is currently set at 200% - 400% of SCR. In comparison, the Day 1 SII results for the Society indicated a Capital Ratio of 343% with own funds of £26.4m and an SCR of £7.7m.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The Directors are responsible for preparing the SFCR in accordance with the Prudential Regulation Authority ('PRA') rules and SII regulation.

The PRA Rulebook for SII firms in Rule 6.1 (2) and Rule 6.2 (1) of the Reporting Part requires that the Society must have in place a written policy ensuring the ongoing appropriateness of any information disclosed and that the Society must ensure that its SFCR is subject to approval by the Directors.

Each of the Directors, whose names and functions are listed in the Board of Directors section of the Report and Accounts, confirm that, to the best of their knowledge:

(a) Throughout the financial year in question, the Society has complied in all material respects with the requirements of the PRA rules and SII Regulations as applicable; and
(b) It is reasonable to believe that, at the date of the publication of the SFCR, the Society continues so to comply, and will continue so to comply in the future.

By Order of the Board

Donald P Ratcliffe

D P Ratcliffe

Secretary

16 May 2017

Report of the external independent auditor to the Directors of Metropolitan Police Friendly Society Limited ('the Society') pursuant to Rule 4.1 (2) of the External Audit Chapter of the PRA Rulebook applicable to Solvency II firms

Report on the Audit of the relevant elements of the Solvency and Financial Condition Report

Opinion

We have audited the following documents prepared by Metropolitan Police Friendly Society Limited as at 31 December 2016:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report of Metropolitan Police Friendly Society Limited ('the Society') as at 31 December 2016 (**'the Narrative Disclosures subject to audit'**); and

- Society templates S02.01.02, S12.01.01, S23.01.01, S25.01.21 and S28.01.01 (**'the Templates subject to audit**').

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

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

- The 'Business and performance', 'System of governance' and 'Risk profile' elements of the Solvency and Financial Condition Report;

- Society templates S05.01.02 and S05.02.01;

- the written acknowledgement by management of their responsibilities, including for the preparation of the Solvency and Financial Condition Report (**'the Responsibility Statement'**).

In our opinion, the information subject to audit in the relevant elements of the Solvency and Financial Condition Report of the Society as at 31 December 2016 is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as modified by relevant supervisory modifications, and as supplemented by supervisory approvals and determinations.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK and I)"), International Standard on Auditing (UK) 800 ("ISA (UK) 800") and International Standard on Auditing (UK) 805 ("ISA (UK) 805") and applicable law. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Relevant Elements of the Solvency and Financial Condition Report* section of our report.

Emphasis of Matter - Basis of Accounting

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

Responsibilities of Directors for the Solvency and Financial Condition Report

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

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

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

It is our responsibility to audit and express an opinion, in accordance with applicable law, ISAs (UK and I), ISA (UK) 800 and ISA (UK) 805, as to whether the relevant elements of the Solvency and Financial Condition Report are prepared, in all material respects, with financial reporting provisions of the PRA Rules and Solvency II Regulations on which they are based. ISAs (UK & I) require us to comply with the Auditing Practices Board's Ethical Standard for Auditors.

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's web-site at www.frc.org.uk/auditscopeukprivate.

This report, including the opinion, has been prepared for the Directors of the Society to enable them to comply with their obligations under External Audit rule 2.1 of the Solvency II Firms Sector of the PRA Rulebook and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Directors for our audit work, for this report, or for the opinions we have formed.

Report on Other Legal and Regulatory Requirements

In accordance with Rule 4.1 (c) of the External Audit Chapter of the PRA Rulebook we are required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of Metropolitan Police Friendly Society Limited statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this Other Information, we are required to report that fact. We have nothing to report in this regard.

Raymond Tidbury

for and on behalf of Mazars LLP
Chartered Accountants and Statutory Auditor
Tower Bridge House
St Katharine's Way
London E1W 1DD

16 May 2017

A. BUSINESS AND PERFORMANCE

A.1 Description of the Business
including Material Lines of Business, Capital Structure, Auditors

A.1.1 Legal Structure

Metropolitan Police Friendly Society Limited ('Metfriendly' or 'the Society') is a friendly society, incorporated under the Friendly Societies Act 1992 and registered in the United Kingdom (registered number 496F). The Society's registered office is at Central Court, 1B Knoll Rise, Orpington BR6 0JA.

The Society is dual regulated under registered number 110026 by both the Financial Conduct Authority ('FCA') and the Prudential Regulation Authority ('PRA'). As an FCA designated flexible portfolio firm and a PRA designated P5 firm, the Society does not have individually named supervisors. Contact details for each regulator are as follows:

> FCA: 5 The North Colonnade, London E14 5HS firm.queries@fca.org.uk Freephone 0800 111 6768
>
> PRA: Bank of England, Threadneedle Street, London EC2R 8AH firmenquiries@bankofengland.co.uk Phone 020 7601 4444

The Society's auditor is Mazars LLP, Tower Bridge House, St Katharine's Way, London E1W 1DD.

The Society is a mutual organisation, owned by its members (i.e. its policyholders) and has no shareholders. At General Meetings, each member over the age of 18 has one vote, irrespective of the number of policies they hold, and all votes count equally.

The Society is not part of a group and has no subsidiaries.

A.1.2 Description of the Business

Metfriendly operates solely in the UK and individuals living outside the UK are not eligible to take out policies with the Society. Members with policies who move abroad may not normally take out additional policies.

The Society's mission statement is as follows:

> "**Metfriendly is here to give members of the police family the opportunity to provide for their future financial security through education, information and fair value products.**"

Membership of the Society is restricted to current and former police personnel and their family members, with Metfriendly focussing its sales and marketing activities in the London area in order to achieve the most cost effective results - providing a well-defined affinity group. Employees of the police service in London are able to make payments to the Society by regular deduction from salary.

As at 31 December 2016 the Society had assets of approximately £140m, membership of 12,619 and 19 employees (plus 8 non-executive directors).

The Society provides medium to long-term savings and investment products as well as protection policies, each of which is outlined in turn below. It does not provide cash savings accounts in any format. All savings and investment products are with-profits with the exception of the guaranteed 5 year savings plan (see below).

Savings products include 'stocks and shares' ISAs for adults and Junior ISAs for children to facilitate monthly savings. Both are subject to minimum and maximum monthly amounts, and the annual limits imposed by statute. Returns earned depend on the performance of the With-Profits Fund (see below).

Metfriendly also offers 5 year regular savings plans with guaranteed returns, depending on the regular fixed monthly savings amount (at least £20 per month) that is chosen at the start of the five year period.

Longer-term savings plans are also available. A ten year savings plan allows monthly payments between £25 per month and £300 per month, with the first £25 per month being tax exempt (subject to a maximum of one such tax exempt policy per person – whether with the Society or another organisation). Longer terms of 11 to 25 years can no longer be taken out, but some older plans of this duration are still active.

Investment products are provided in the form of lump sum stocks and shares ISAs (minimum amount £1,500) for adults. These are also available as Junior ISAs for children, again with a minimum amount of £1,500. Both are subject to the annual maximum limits allowed by statute. The Society also offers With Profit Bonds, subject to a minimum amount of £1,500. These lump sum products have no fixed-term, but are intended for the longer-term, with annual bonuses and eligibility for a final bonus after at least three years.

Protection plans are designed to provide income protection for police officers and police staff in the event of sickness, critical illness or injury. Life insurance protection is also available, either as a fixed sum or a reducing amount (for instance to cover the diminishing balance on a repayment mortgage).

The Society's With Profits Fund is invested in a range of assets spread across several investment funds, with diversified allocations in equities, corporate bonds and property. The investment strategy aims to provide returns that are significantly better than those available on government bonds. Surplus funds in excess of asset shares are backed by cash deposits, liquidity funds and bond funds; as are policies which are not with-profits (guaranteed savings and protection plans).

A.1.3 Significant External Events in 2016

The most significant events that have occurred over 2016 to impact the Society are those arising from the result of the UK referendum vote to leave the EU in June 2016; and the potential for further international uncertainty for economic and political direction following the US election result. Whilst to date these developments have not had any adverse impact on new business levels or increased surrenders, they have caused uncertainty in the wider economy and investment markets; and this background of uncertainty will continue for some time. These events did lead to a further cut in UK interest rates, weakening of sterling, and raised expectations of increases in inflation and continuing economic and political uncertainty. The current low interest rate environment is considered to be one of the factors that contributed to the significant levels of lump sum ISA business written by the Society in 2016, whilst weakening of sterling contributed to a surge in equity values in the second half of the year, in the expectation that exporters and UK listed companies with multi-national interests would benefit from this.

A.2 Underwriting Performance

The underwriting result encompasses premiums plus allocated investment returns; less claims, expenses, taxation and the increase in technical provisions, as reported in the accounts. For 2016, the result was an underwriting loss of £2.5m (2015: a loss of £0.2m). The following table shows how the 2016 result arises by line of business, including items attributed to capital which are covered in the following sections. All business was written in the UK. Accumulating with profits business is written as single premium business with no fixed term (single premiums include recurrent premiums initiated by the member in prior years. The member retains the right to vary or suspend such premiums without penalty). Conventional with profits business is written as regular premium business with a fixed payment term.

	Accumulating With Profits	**Conventional With Profits**	**Other Savings**	**Protection**	**Attributed to capital**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**
Premiums	17.4	3.3	2.7	0.5		**23.9**
Investment Return	7.7	2.4	0.2	0.1	**1.6**	**12.0**
Claims	(4.5)	(7.8)	(0.2)	(0.3)		**(12.8)**
Expenses	(1.7)	(0.4)	(0.2)	(0.1)		**(2.4)**
Taxation	(0.5)	-	-	-	**(0.1)**	**(0.6)**
(Increase) in Technical Provisions	(21.1)	3.0	(2.7)	0.2	**(2.0)**	**(22.6)**
Total	**(2.7)**	**0.5**	**(0.2)**	**0.4**	**(0.5)**	**(2.5)**

The main underlying factor was an increase in the cost of accumulating with profits guarantees of £2.6m, with other factors offsetting this by £0.1m. The cost of guarantees rose due to a substantial increase in new lump sum business, and a reduction in the rate of interest used to discount these guarantees, consistent with the fall in bond yields over 2016.

Next year, the Society is intending to align its report and accounts with technical provisions required for reporting the results under Solvency II. This will result in a realistic cost for providing future guarantees as there will be a) allowance for future lapse rates, and b) credit for future charges to meet these costs. On this basis the underwriting profit for 2016 was £0.7m. It is expected to remain close to nil over the next 3 years.

A.3 Investment Performance

The Society invests through pooled funds, with expenses charged to those funds. Where the Society receives a rebate of fees from the investment manager, this is recorded as investment income.

The Society identifies investments to meet the asset shares under with profits business. These assets returned £10.1m (i.e. investment income and gains) in 2016, equivalent to a gross investment return of 11.7% (2015: £3.7m, 4.6%).

The residual assets, bonds and cash, returned £1.9m in 2016 equivalent to a gross investment return of 5.7% (2015: £0.2m, 0.6%). Of this, £0.3m was allocated to lines of business and the remaining £1.6m represented a return on capital (2015: nil and £0.2m respectively).

A breakdown of the 2016 investment return is given in the following table.

	Investment Income	**Realised and Unrealised Gains**	**Total (2016)**	**Total (2015)**
	£m	**£m**	**£m**	**£m**
Liquidity and Bond Funds	1.8	2.9	**4.7**	**0.4**
Equity Funds	0.9	6.3	**7.2**	**1.0**
Insurance Linked Security Funds	-	0.1	**0.1**	**0.1**
Property Funds	0.6	(0.7)	**(0.1)**	**2.4**
Deposits and Cash	0.1	-	**0.1**	**0.0**
Total	**3.4**	**8.6**	**12.0**	**3.9**

Investments are selected for long term performance and returns are expected to fluctuate from year to year.

A.4 Other Factors Affecting Performance

The report and accounts includes a technical provision for future expenses in line with the former requirements of Solvency I. This increased by £1.0m in 2016 (2015: increased £0.3m). The increase in this provision reflects increasing expenditure including planned costs arising over the next 5 years.

Expense allowances in the contracts covered actual expenses in 2016 and did not require any call on capital (2015: a call on capital of £0.1m).

Taxation allocated to capital amounted to a charge of £0.1m (2015: a release of £0.1m).

The Society allocated capital of £1.0m to the with-profits contracts in 2016 (2015: nil) in order to increase the asset shares, which will lead to higher future payouts under the affected contracts.

These factors, along with the investment return on capital, are attributed to capital in the underwriting performance shown above. Overall performance led to reported capital, the 'Fund for Future Appropriations', reducing by £2.5m in 2016 (2015: a reduction of £0.2m). The Fund for Future Appropriations stood at £19.6m as at 31 December 2016 (2015: £22.1m).

B. SYSTEM OF GOVERNANCE

B.1 System of Governance

B.1.1 Description of the Board and Committees

The Society's Board of Management ('the Board') is responsible for oversight of the organisation and setting its strategy. As at 31 December 2016 the Board comprised 8 part-time Non-Executive Directors (including the Chair) and 2 full-time Executive Directors (including the Chief Executive Officer). The Chair supported by the Society Secretary, is responsible for leading the Board; whereas the Chief Executive Officer is responsible for leading the Society's operational activity and implementing strategy. 3 of the Non-Executive Directors are former police officers, with the remainder having backgrounds in financial services.

The Chair is responsible for the performance of the Board as a whole. This includes appraising the performance of individual Non-Executive Directors and the Chief Executive Officer. The Senior Independent Director ('SID') (a Non-Executive Director) is responsible for leading an annual review of the Chair's performance, taking into account feedback from other directors. The SID also provided a point of contact for members if they have concerns that they consider not to have been addressed satisfactorily through the normal conduit of the Chief Executive Officer or Chairman. One Non-Executive Director also fulfils the role of With-Profits Non-Executive Director ('WPNED'), leading oversight of the Society's management of its with-profits business and providing independent judgement as required by the FCA.

The governance structure is shown in the table below, comprising five Board committees whose membership, terms of reference and authority are set by the Board. The Chairs of each committee report to the Board at the next Board meeting following each committee meeting.

<table>
<tr><td colspan="5">BOARD OF MANAGEMENT

Mike McAndrew (Chair)
Stuart Bell (Chief Executive Officer)
Tim Birse (Non-Executive Director)
Peter Clarke (Senior Independent Director)
Janet Cassettari (Non-Executive Director)
Fiona Gregory (Non-Executive Director)
Graeme McAusland (Non-Executive Director)
Don Ratcliff (Deputy Chief Executive Officer)
Lee Schopp (Non-Executive Director)
Joanna Young (Non-Executive Director)</td></tr>
<tr><th>Audit and Compliance Committee</th><th>Member Relations Committee</th><th>Nomination and Governance Committee</th><th>Remuneration Committee</th><th>Risk and Investment Committee</th></tr>
<tr><td>Graeme McAusland (Chair)
Tim Birse
Fiona Gregory
Lee Schopp</td><td>Janet Cassettari (Chair)
Stuart Bell
Peter Clarke
Fiona Gregory
Mike McAndrew
Simon Allford*
Ben Grainger*</td><td>Mike McAndrew (Chair)
Janet Cassettari
Fiona Gregory
Joanna Young</td><td>Peter Clarke (Chair)
Fiona Gregory
Mike McAndrew
Joanna Young</td><td>Tim Birse (Chair)
Stuart Bell
Mike McAndrew
Graeme McAusland
Joanna Young
Simon Allford*
Ben Grainger*</td></tr>
<tr><td colspan="5">*Member of Leadership Team, not a Board Director / member of Board of Management
Simon Allford resigned from the Society 31 March 2017</td></tr>
</table>

The role of each Committee is summarised in the following paragraphs.

The **Audit and Compliance Committee** provides independent oversight of the Society's statutory reporting and systems of internal control, as well as ensuring its compliance with the Financial Services and Markets Act 2000 and other relevant legislation. The Committee's role includes supervising and monitoring the independence, quality and effectiveness of the Society's external audit auditor and its internal audit function.

The **Risk and Investment Committee** provides independent oversight of the Society's systems of risk management and investment strategy. This includes reviewing risk appetite, capital management, product pricing, expense analysis and regulatory returns including the Society's SFCR and RSR. The Committee also reviews the Society's ORSA documentation, prior to Board approval.

The **Nomination and Governance Committee** oversees the Society's senior management arrangements and makes recommendations to the Board on matters relating to the appointment of Executive and Non-Executive Directors and individuals performing Senior Insurance Management Functions (SIMF) roles. It also keeps the Board's governance arrangements under review and makes appropriate recommendations to ensure that these are consistent with appropriate and proportionate governance practices.

The **Remuneration Committee** oversees and recommends to the Board matters relating to the remuneration of Executive and Non-executive Directors.

The **Member Relations Committee** ensures that there are appropriate arrangements in place to ensure that there is appropriate dialogue between members of the Society and the Board and to ensure the fair and appropriate treatment of members. It also has responsibility for reviewing key communications with members and proposals for any additional services or membership benefits.

The Chief Executive oversees the Society's operations through a Leadership Team comprising himself, the other Executive Director, and three senior managers being the Finance Director, Sales & Marketing Director, and IT Manager.

B.1.2 Changes to the System of Governance During 2016

During 2016 a review was carried out of the structure and terms of reference of the Society's Board committees. The main changes arising from this review are set out below:

Previous Committee	New Committee	Rationale for Change
Audit, Risk and Compliance Committee	Audit and Compliance Committee	Oversight of risk, including controls, transferred to the Risk and Investment Committee – consistent with PRA's preferred approach and to reduce the Audit & Compliance Committee's breadth of responsibilities.
Finance and Investment Committee	Risk and Investment Committee	Separate Risk Committee consistent with PRA's preferred approach. Investments are a key area of risk for the Society.
Business Development Committee	Member Relations Committee	New Committee to ensure facilitation of dialogue and feedback between the Board and membership. Strategic aspects of development previously overseen by the Business Development Committee to be overseen by the Board in response to recommendations from the Leadership Team.
Nomination Committee	Nomination and Governance Committee	Logical extension of this committee's remit to include governance arrangements such as Board committee structure; and allocation of Senior Investment Management Function ('SIMF') roles.

The establishment of a Leadership Team during the year led by the Chief Executive Officer strengthened oversight of the Society's operations and provides a more focussed forum for the development of strategy than was the case previously when a wider group of managers met to review issues.

B.1.3 Remuneration Practices and Policy

The Society's policy for remuneration is to attract and reward senior managers (including Executive Directors) and staff with annually reviewed fixed salaries that recognise their skill set and responsibilities, with changes to senior managers' salaries subject to review by the Remuneration Committee. In common with many smaller mutual societies, there is no variable element (i.e. bonus scheme, shares or share option schemes) to the remuneration paid to senior managers. This is on the basis that given the diverse nature of their responsibilities in a smaller organisation the inevitable focus on narrower incentive targets would be a distraction from competing priorities for senior managers when carrying out their roles. There are no incentive schemes for staff, other than a modest reward scheme for field staff based on numbers of member events and interactions achieved each quarter. Commission and incentives are not paid according to individual sales results. Share options and share incentives cannot be offered because of the organisation's mutual status.

All employees and senior managers are entitled to join a defined contribution group personal pension provided by the Society with employer's contributions of 5% of salary. This contribution increases to 9% of adjusted salary if employees choose to opt into a salary sacrifice arrangement of 2.5%. No early retirement schemes are available for employees or senior managers.

Non-Executive Directors' remuneration comprises a fixed annual amount which recognises the responsibilities held (for instance chairing a Board committee) and an attendance fee for Board and committee meetings which is set to reflect typical consultancy fees in the financial services sector. No contributions are made to any pension arrangements on behalf of Non-Executive Directors.

There were no material transactions between the members of Metfriendly's Board (and its employees) and the Society in 2016. Whilst members of the Board who meet the eligibility criteria for membership are permitted to subscribe to Metfriendly policies and plans on normal terms (on their own behalf and that of close family members), these holdings are monitored with annual confirmation at Board level that none are considered material.

B.2 Fitness and Propriety

B.2.1 Fitness and Propriety Requirements

The Society requires all personnel responsible for the organisation's oversight and key functions to have the requisite skills, qualifications, knowledge and experience to fulfil their roles and responsibilities effectively, through their professional qualifications depending on the role (for instance accountancy, actuarial, legal, HR, managerial); or through their knowledge and experience (for instance holding similar positons elsewhere, or thorough senior experience of working with a police service or other membership based entity). Requirements include ensuring that Non-Executive Directors have sufficient time to fulfil their responsibilities, are independent (and are seen to be independent), have no material conflicts of interest, and demonstrate the character, integrity and behaviours conducive to being regarded as a 'fit and proper' person.

B.2.2 Fitness and Propriety Assessment

The Society assesses fitness and propriety on the appointment of a Non-Executive Director and any other key function holders on appointment (whether they are an existing member of staff or externally appointed) to ensure their honesty and financial soundness. This is done through carrying out background screening using the Disclosure and Barring Service (DBS) checks. Unless the nature of the position allows Metfriendly to ask questions about applicants' entire criminal record, it only asks about 'unspent' convictions as defined in the Rehabilitation of Offenders Act 1974. The Board ensures that all those in Metfriendly who are involved in the recruitment process have been suitably trained to identify and assess the relevance and circumstances of offences, and that they have received appropriate guidance and training in the relevant legislation relating to the employment of ex-offenders, e.g. the Rehabilitation of Offenders Act 1974; and the recruitment policy provides a further safeguard that these matters are fully addressed. At interview, or in a separate discussion, the Society ensures that an open and measured discussion takes place on the subject of any offences or other matter that might be relevant to the position. Failure to reveal information that is directly relevant to the position sought could lead to withdrawal of an offer of employment. Having a criminal record will not necessarily bar applicants from working with the Society. This will depend on the nature of the position and the circumstances and background of the offences.

For external appointees references are also sought, including information about any outstanding liabilities for commission payments, any relevant outstanding or upheld complaint against the candidate from an eligible complainant, and any information concerning their fitness and propriety to act in the relevant position.

On appointment, all SIMF holders and directors are required to complete the Fitness and Propriety declaration which forms section 5 of the Form A Application that is submitted for regulatory approval. An annual re-declaration is also required, with affirmations required in respect of the same questions asked on the Form A Application; together with confirmation that, taking into account the Society's Conflicts of Interests Policy, the individual is not aware of any personal interests, obligations, or other situations that could conflict with the performance of the controlled functions they perform.

At the start of each Board meeting, those present are also asked to declare whether they are aware of any personal conflicts of interest in relation to the agenda items.

Assessment of fitness and propriety of Board members and those holding regulated positions is also supported by:

- Staff and director appraisal processes
- Annual Board self-evaluation
- Triannual externally facilitated Board evaluation exercise

The Society's Conduct Risk Policy which is owned by the Board applies to all employees and directors, requiring them to observe all relevant FCA principles for business relating to conduct including: acting with integrity, due skill, care and diligence treating customers fairly; and managing any conflicts of interest fairly.

The tables below set out the Society's Senior Insurance Management Functions, followed by the Key Function Holders:

SIMF	**HOLDER**
SIMF1 Chief Executive function	Stuart Bell
SIMF2 Chief Finance function	Stuart Bell
SIMF4 Chief Risk function	Stuart Bell
SIMF5 Head of Internal Audit function	John Midlane
SIMF9 Chairman	Mike McAndrew
SIMF10 Chair of the Risk Committee	Tim Birse
SIMF11 Chair of the Audit Committee	Graeme McAusland
SIMF12 Chair of the Remuneration Committee	Peter Clarke
SIMF14 Senior Independent Director	Peter Clarke
SIMF20 Chief Actuary function (outsourced)	Lindsay Unwin*
SIMF21 With-Profits Actuary function (outsourced)	Lindsay Unwin*
Whistleblowing oversight function	Graeme McAusland
CF2a Chair of the Nomination Committee	Mike McAndrew
KEY FUNCTIONS	**HOLDER**
(1) Risk Management function	Stuart Bell
(2) Actuarial function (outsourced)	Lindsay Unwin*
(3) Internal Audit function	John Midlane
(4) Compliance function	Stuart Bell (Solvency II) John Midlane (FCA COBS)
(5) Investment function	Stuart Bell
(6) IT function	David Hurcomb
(7) any other function which is of specific importance to the sound and prudent management of the firm	Tim Birse (WPNED)
(8) the function of effectively running the firm	Mike McAndrew (Chair) Peter Clarke (NED & SID) Tim Birse (WPNED) Janet Cassettari (NED) Fiona Gregory (NED) Graeme McAusland (NED) Lee Schopp (NED) Joanna Young (NED) Stuart Bell (ED, CEO) Don Ratcliffe (ED, Deputy CEO)

* Lindsay Unwin is an employee of Milliman LLP, with whom the Society has entered an outsourced services agreement.

B.3 Risk Management System

B.3.1 Risk Management Overview

The Society's Risk Policy sets out how risk is managed by the organisation to ensure that risks are appropriately managed. This is supported by the Society's 'Values and Standards' which set out values and expected behaviours that underpin culture including risk culture within the organisation, and are set by the Board. These include the exercise of prudence and judgement in financial management, including the requirement to manage members' funds safely and soundly, but avoiding excessive caution which could unduly reduce returns to members. The Society's Risk Policy recognises that there are natural tensions to consider in relation to risk tolerance, including:

- achieving good levels of new business, including new members; whilst being mindful that new business can deplete capital, and inappropriate sales would cause reputational risk;
- achieving good investment returns through exposure to assets such as equities and property that can fluctuate in value, and inevitably are a source of risk:
- management of operational risk, whilst recognising that there are points beyond which the cost of further control improvements to reduce risks will be disproportionate as the incremental value of control benefits diminish.

Risk appetite is set at a conservative level to ensure capital strength is not compromised, and at the same time, does not compromise the ability to achieve good investment returns for members. This is reflected in the overarching aim of ensuring the Solvency Capital Requirement (SCR) under the Solvency II regime is covered within a range which is currently set at 200% to 400%. A wide target range of coverage is adopted to recognise that the Society's SCR and capital are both sensitive to economic conditions. An additional test is used to assess whether there may be excessive levels of capital – regarded as being a level in excess of 30% of asset shares plus 20% of residual liabilities (with the latter currently comprising only a minor element). Residual liabilities comprise the best estimate liabilities, net of reinsurance, for the non-profit business, the risk margin and net cost of providing for with-profits guarantees.

The Society uses the Standard Formula basis to assess its solvency capital requirements, and does not use an internal model for any aspect of the capital assessment.

B.3.2 Implementation of Risk Management System

Risk governance is overseen by the Board, with detailed review carried out by the Risk and Investment Committee on its behalf, including regular review of the Society's risk register, normally at least quarterly. The Committee reports the results of its review to the Board; and additionally the strategic and material risks are also further considered by the Board itself. These include risks such as failing to maintain membership levels, the ability to ensure expense costs can be covered from income, and the risk of a mismatch between the Society's assets and liabilities. At operational level, the Society's Leadership Team oversees operational risks, as well as reviewing new and emerging risks, and any changes to risk assessment factors or significant controls.

Key risk management information is highlighted within the Society's quarterly management information pack received by all Board members and attendees. This includes a dashboard summary of key performance indicators measured against targets and ranges of tolerance. These are focussed on key areas of risk: membership numbers, new business levels, investment returns, expense levels, and the matching of assets against liabilities. The quarterly management information pack also includes details of the latest assessment of the most strategic and material risks for Board consideration, both before and after the application of controls.

Risks are detailed in the Society's risk register by showing inherent risk scores for individual risks by reference to the likelihood of them occurring and the impact should they crystallise. Risk statements provide an explanation of each risk, what high level documentation and controls are in place, and rationale for the risk scores for each. Risk triggers have also been identified to show the point at which management actions would be considered (for example if expenses differed materially from budget).

Residual risk is assessed by considering the effectiveness of controls in place to mitigate the likelihood and impact of each risk occurring; and those risks with the largest residual scores are reviewed by the Board.

For all risks, Metfriendly seeks to ensure that, after allowing for controls, the likely impact is well within available capital (less than 10%).

Section B4 below provides an overview of how the Society's risk management is implemented and integrated into the organisational structure, and decision making process, as reflected in its ORSA.

As part of the ORSA detailed in section 4 below, when carrying out required stress and adverse scenario testing, an assessment is made of the most significant risks faced by the Society so that these are used as the basis for testing the resilience of the Society's capital coverage in adverse circumstances. This helps further inform the Society's approach to capital management, including risk appetite assessments and identification of trigger points when management actions would be considered to protect capital coverage should extreme circumstances (for example a severe market crash).

Risk is a standing agenda item at meetings of the Society's executive Leadership team, which are normally held fortnightly or more frequently if required. This enables regular consideration of any changes to risk profiles and key controls – whether these arise from operational or external factors – as well as any emerging risks, ensuring that risk management is fully integrated into the decision-making process. It also enables follow-up actions including any changes to the risk register to be identified and implemented swiftly. The impact of any potential strategic plans on the Society's risk profile is taken into account, including forward capital projection estimates if appropriate. The Society's Chief Risk Officer and Chief Actuary attend all Board meetings (including strategy discussions), as well as meetings of the Risk and Investment Committee, ensuring that risk management is integrated into the organisational structure. As a small organisation, the Society's management work closely alongside other staff, enabling risk issues to be raised and recognised as they occur.

B.4 Own Risk and Solvency Assessment (ORSA)

B.4.1 Description of ORSA Process

The Society's ORSA process is conducted throughout the year to ensure integration with decision-making. It comprises a number of key iterative activities that take part during the business planning and finance and risk management annual reporting cycles as summarised below, culminating in the ORSA report itself:

ORSA Process	Detail	Review and Approval Process	Timing
Business Plan	Overview document of the Society's annual business plans, including revenue projections and supported by a Business Development Plan and expense budget.	First Board review	December
		Second Board review and approval	February
Investment Strategy	Annual review of investment strategy including setting target ranges and limits for the allocation of funds to different types of investment asset (broadly cash and cash equivalents, bonds, equities and property). These are set by reference to liability guarantees, as well as needing to provide returns to meet members' reasonable expectations for investment and savings products.	Review by Risk & Investment Committee	January
		Board review and approval	February
Expense Review	This is an annually refreshed review of expenses over the previous 5 years, and is used to allocate costs to different product types according to the amount of work involved in selling and administering them.	Review by Risk & Investment Committee	January
		Board review and approval	February

ORSA Process	Detail	Review and Approval Process	Timing
Statutory Solvency	In 2016 this assessment comprised a detailed report from the Society's Actuarial Function Holder, setting out an analysis of the organisation's assets, long-term liabilities and capital requirements as at 31 December 2015.	Review by Audit & Compliance Committee	March
		Board review and approval	March
	Further to this, the Chief Actuary provided a report setting out the Society's equivalent 'Day 1' capital position on the Solvency II basis effective 1 January 2016.	Board review and approval	May
	The CEO / CRO carried out a quantified review of the Society's Operational Risk Capital requirement.	Board review and approval	August
Risk Policy	Document setting out how the organisation manages and measures risks - this is reviewed and updated annually or more frequently as required.	Review by Risk & Investment Committee	July
		Board review and approval	July
Investments and Savings Product Review	Review of savings and investment products open to new business, to ensure that it remains appropriate to continue to offer them under current terms.	Review by Risk & Investment Committee	July
		Board review and approval	July
Forward Looking Assessment of Own Risks (FLAOR)	This report analyses the most material risk the Society faces according to its own assessments – e.g. an extreme investment market crash - and its ability to withstand it from a capital perspective.	Board discussion of stress tests to be performed	May
		Board review and approval of FLAOR results.	July
Reverse Stress Test (RST)	This report fulfils a regulatory requirement to consider what future events could cause the Society's business model to be unviable; and hence to help the firm's Board and Executive better understand risks facing the organisation and how they may be mitigated.	Review by Risk & Investment Committee	October
		Review and approval by Board	October
ORSA Report	This is a summary report which cross-references and includes all the documents noted above. Following Board approval, it is submitted to the PRA.	Review by Risk & Investment Committee	October
		Review and approval by Board	October
Review Process	Consider any further enhancements to the ORSA report and process in light of specific of general feedback from the PRA.	Risk & Investment Committee	December / January

B.4.2 Review and Approval of ORSA

The ORSA process is owned by the Board, with each element of the report being reviewed and approved by it, following review by the executive Leadership team. The Board's own review of each element will normally follow in-depth review by a relevant Board committee. The final ORSA report is also reviewed and approved by the Board prior to annual submission to the PRA. In the event of a significant change to the Society's risk profile or business model, individual elements of the ORSA would be updated.

The ORSA report considers the appropriateness of the standard formula under Solvency II to the capital needs of the Society. The Society has determined that the standard formula results in capital resource requirements which are appropriate to the Society's risk profile, such assessments are reviewed annually.

As summarised in the table in B.4.1 above, the ORSA process is carried out throughout the year, ensuring that it is fully integrated with decision-making processes, culminating in the ORSA report which is owned by the Board. The Chief Risk Officer coordinates the relevant processes, with input from the Society's relevant subject matters experts; and ensures that review and challenge is sought and reflected from the Leadership Team, Risk & Investment Committee and the Board at the appropriate time.

The results of the Forward Looking Assessment of Own Risks and Reverse Stress Test, together with review of the ongoing appropriateness of the Standard Formula ensure that the organisation's solvency needs are appropriately calculated; and integrated with the risk management system.

B.5 Internal Control Function

B.5.1 Internal Control System

The Society has a financial control framework which underpins its financial reporting and regulatory reporting. This includes controls over data and data security to ensure that confidentiality is maintained, whilst also ensuring that policyholder is accurate and complete so that valuation data used to compute the Society's assets is robust; as well as controls to address the risk of fraud and errors, including material misstatements in its statutory reports. They comprise manual and automated controls, reconciliations, segregation of duties, clearly delegated authority levels, and evidencing that controls have been carried out.

The internal control system is subject to internal audit review, overseen by the Audit & Compliance Committee. The external auditor also carries out controls testing as part of statutory audit work, and reports any recommendations for improvements to the Audit & Compliance Committee which follows up the implementation of any actions agreed in response. Key procedures include policy data reconciliations for the six months to 30 June and 12 months to 31 December to check the integrity of data (e.g. opening and closing policy counts, sums assured and asset shares); premiums and controls reconciliations between the policyholder system and the accounting system; bank reconciliations; investment accounting reconciliations; cash flow monitoring against projections; reassurance account reconciliations; payroll reconciliations; outstanding debtor and creditor analysis; and variance analysis to inform understanding of any differences between budgeted and actual expenditure. Valuation results are supported by analysis of movements between opening and closing actuarial liabilities and reserves; whilst components of change for key elements of capital such as surplus are also analysed to provide further assurance.

The Society's financial statements are subject to further controls in their production and review; and actuarial liabilities are assessed using actuarial best practices and are subject to review by the Risk & Investment Committee. Following internal and external audit review of the financial statements, they are presented to the Audit & Compliance Committee for detailed review, prior to final review and approval by the Board.

B.5.2 Compliance Function

The compliance function is carried out by an experienced in-house Compliance Officer who does not have any other operational role within the organisation, avoiding the possibility of any conflict of interest. The Compliance Officer reports to the Deputy Chief Executive Officer for operational matters, but the compliance function reports to the Audit & Compliance Committee at least quarterly. The Audit & Compliance Committee's remit includes ensuring that the Compliance Officer has sufficient resource to carry out his duties, and has full access to the information he requires to do so. The Committee approves the annual Compliance Plan for assurance activities and monitors progress against the plan.

The Compliance Officer also oversees the internal audit function. These roles are considered to be complementary, ensuring consistency of approach and avoiding duplication.

B.6 Internal Audit Function

The Society's internal audit function is managed by the Society's Compliance Officer who is the appointed Head of Internal Audit. Performance of internal audit activity is outsourced, principally to RSM Risk Assurance Services LLP, with a three year rolling plan of testing which is updated and reprioritised as required, and at least annually, in line with business requirements and risk assessments. Further internal audit work on the underwriting of protection claims is carried out annually by an external expert.

The Audit and Compliance Committee is responsible for ensuring that the internal audit function is independent and objective. This Committee considers the appointment and remuneration of the internal auditor and meets at least annually with the internal auditors without management present. The Committee is responsible for reviewing and agreeing the internal audit test plan, and for ensuring that the internal audit function is adequately resourced and has access to the information it needs to carry out its role effectively. All internal audit reports are reviewed by the Audit and Compliance Committee which reviews the appropriateness, timing and implementation of management's responses to any recommendations that are made.

B.7 Actuarial Function

The Society's actuarial function is overseen by the Chief Executive Officer who is the Society's Chief Risk Officer and a Fellow of the Institute and Faculty of Actuaries. The roles of Chief Actuary (SIMF20 under the Senior Insurance Management 'SIMF' regime, and previously the Actuarial Function Holder role) and With-Profits Actuary (SIMF21) are outsourced and held by an experienced senior actuarial consultant at Milliman LLP. The holder of these roles is a Fellow of the Institute and Faculty of Actuaries and holds the required Practising Certificates. In carrying out her work she is supported by other qualified actuaries within Milliman.

B.8 Outsourcing

The Society's outsourcing policy requires due diligence to be carried out and appropriately evidenced on all potential outsourced service providers. For new contracts for material outsourcing arrangements (recurring annual fee over £50,000), pre-approval is required and the Risk and Investment Committee will review any proposal and recommend whether or not it should be approved by the Board. This must be supported by an assessment of the impact on the Society's risk profile arising from the proposed arrangement, or from any proposed change in outsource service provider. All outsourced arrangements must also be reviewed annually to ensure they remain fit for purpose.

The outsourcing contract with the service provider must include documented service level agreements, details of management information to be provided, and arrangements for service monitoring, relationship management and escalation procedures in the event of poor performance including arrangements for early termination if necessary.

An appropriate manager is appointed as the individual responsible for overseeing the services provided by the outsourced services provider on behalf of Metfriendy.

The following services that are outsourced by the Society are considered to be important or critical to the organisation:

- Actuarial services
- Internal audit services
- Outbound printing and distribution
- Elements of IT support (including some desktop support, telephony and storage)
- Payroll processing
- SII data reporting fulfilment

All the Society's outsourced services providers operate under UK jurisdiction.

As a small organisation, the Society's senior managers work closely with outsourced service providers. They are therefore well aware of ongoing service levels and quality of service, enabling any issues of concern to be raised and resolved promptly, without needing to invoke contractual escalation procedures which are available should they be needed.

B.9 Adequacy of the System of Governance

The Society's system of governance is considered to be appropriate, taking into account the nature, scale and complexity of the risks inherent in the business. Its organisational structure and reporting lines reflect good practice as set out in the Annotated Corporate Governance Code for Mutual Insurers, against which the Society achieves a very high level of compliance on an annual basis. Further evidence of the appropriateness of the governance system is provided by relevant reports received from internal audit, compliance and external audit in the course of their work.

C. RISK PROFILE

C.1 Underwriting Risk

The underwriting risks faced by the Society largely relate to its ability to recover its expenses from product margins. The Society is willing to meet limited excess expenditure from its own funds (capital). That expenditure is undertaken with a view to covering costs in the medium term. Currently such excess expenditure has 2 components –

- Resources directed at increasing new members, where a large part of the resulting product margins emerge over the long term (e.g. through repeat business). Planned costs in this area have increased since the Society's previous business plan.
- Transitional costs relating to succession and expansion plans for senior management, through to 2019.

Whilst a balance was achieved in 2016, the Society expects aggregate expense overruns of up to £0.6m p.a. in the period 2017-18, reducing thereafter, primarily due to the Society's business development plans.

Lapse rates are reviewed annually with modest and infrequent variations for all significant Society products.

For most of the Society's products, mortality and morbidity risk is minimal. Reinsurance protection is effected for the larger risks arising under protection policies –

- For life insurance policies (including mortgage protection), there are quota share treaties – for new business 70% is currently reinsured with Gen Re.
- For income protection policies, a quota share of 20% is reinsured with Gen Re. The Society can, and does, review the premium rates charged for this business – including for existing business.

Whilst protection policies provide significant margins from their premiums (covering around 10% of total expenses), fluctuations from claims experience are modest.

With the exception of increased planned expenditure, there have been no material changes during 2016. Underwriting Risks account for a minor part of the Society's overall capital requirement. The Society considers such risks as part of its ORSA processes, including an annual review of the products on offer and their terms. The Society believes that the Standard Formula is an appropriate way to quantify underwriting risks. The aggregate net (after allowance for the loss-absorbing capacity of technical provisions) solvency capital requirement for such risks as at the end of 2016 (before any allowance for diversification benefit between risk modules) is £1.1m (2015 - £1.0m).

C.2 Market Risk

Market risk is the major quantitative risk faced by the Society. The Society considers that its members would expect it to seek the rewards associated with investing in real assets, and it does not seek to mitigate the exposure to market fluctuations. The Society does not hedge currency risk on equities.

Market risk derives from the Society's holdings in corporate bonds, equities and UK real property, which are currently all held through pooled funds, thereby avoiding any significant concentration risk. Equity and property assets are allocated entirely to the asset shares backing the Society's with-profits contracts; they currently account for about 44% and 16% of those asset shares respectively – with bond (and liquidity) holdings accounting for the balance.

Fluctuations in asset prices are matched by corresponding movements in the asset shares; in the case of corporate bonds the Society's capital is also exposed.

When asset shares fall in value, the cost of future guarantees will rise. Most of this guarantee cost is now associated with the accumulating with-profits products. For such business written since 2013, the only guarantee is that applying on death; however, the Society would expect to enhance asset shares modestly on surrender claims rather than applying a Market Value Reduction (MVR). The cost of subsidising MVRs in this planned manner is treated as a guarantee cost.

The Society has well diversified holdings in corporate bonds, equities and property, and it considers that these assets will perform broadly in line with general market movements. It recognises that the allowance for equity price stress to accommodate recent market movements (the symmetric adjustment) only provides limited protection in a falling market – accordingly, it expects its capital coverage to fluctuate with market conditions.

There have been no material changes in market risks during 2016, but the amount of risk assumed has increased due to high new business levels. The Society considers such risks as part of its ORSA processes, including an annual review of the products on offer and their terms. The Society believes that the Standard Formula is an appropriate way to quantify market risks. The aggregate net (after allowance for the loss-absorbing capacity of technical provisions) solvency capital requirement for such risks as at the end of 2016 (before any allowance for diversification benefit between risk modules) is £6.7m (2015 - £6.7m).

In the Society's wider consideration of its capital requirements, it would –

- Test the effect of price stresses significantly greater than those underlying the Standard Formula, and/or
- Test stresses in combination, effectively taking no credit for diversification.

C.3 Credit Risk

Credit risk derives mainly from the Society's holdings in Corporate Bond and Liquidity funds; using pooled funds avoids any significant concentration risk. These assets are partly allocated to asset shares with the balance held to meet other liabilities (including the residue constituting own funds). The funds held are mainly invested in investment grade stocks with only a small proportion below investment grade or unrated, mitigating the potential default risk. The Society limits its holdings in cash which normally comprise less than 5% of total assets in aggregate, all investment grade. Credit risk also derives from the Society's reinsurance assets which form only a small proportion of its total assets. The Society monitors the credit ratings of the 2 reinsurers, currently both AA.

The funds allocated to asset shares have an average duration of about 7 years. To the extent to that they fluctuate in value, whether due to market or credit movement, this impacts the liabilities in a similar manner although guarantee costs will rise when prices fall. The remaining funds have an average duration of about 3 years and are less sensitive to market movements. This is considered appropriate for the funds standing behind the Society's capital requirement.

Through the pooled funds, the Society holds a diverse mix of sterling-denominated bonds, typical of their type, suited to matching its liabilities.

There have been no material changes in credit risks during 2016, but the amount of risk assumed has increased due to high new business levels. The Society considers such risks as part of its ORSA processes, including an annual review of the products on offer and their terms. The Society believes that the Standard Formula is an appropriate way to quantify market risks. The aggregate net (after allowance for the loss-absorbing capacity of technical provisions) solvency capital requirement for such risks as at the end of 2016 (before any allowance for diversification benefit between risk modules) is £0.4m (2015 – 0.3m).

C.4 Liquidity Risk

The amount of credit taken for profit inherent in future premiums is immaterial and is not considered to represent any liquidity risk for the Society.

Liquidity risk is considered minimal as the Society limits its illiquid assets to less than 20% of total assets. Given the size of its own funds this provides ample assurance that assets could be realised to cover any conceivable run on its funds.

There have been no material changes in liquidity risk during 2016.

C.5 Operational Risk

The Society considers reputational risk to be significant. In particular, it therefore adopts a highly risk averse approach to safeguarding policyholder data. Transmission of such data is always encrypted, and the Society conducts annual penetration tests on its firewall and website.

The Society assesses the likely maximum quantitative impact of various risks allowing for the effect of the risk controls which are in place – underwriting (error), human resources, compliance, data security, systems and controls, customer care, outsourcing, IT systems, and business continuity. For this purpose, no account is taken of the potential loss of future business from damage to reputation – although risk management does score reputation highly in the Risk Register.

The Society considers that, after diversification, capital required to cover quantifiable operational risks is in the region of £0.6m.

Although there have been no material changes in the profile and nature of operational risk during 2016, the quantification under Solvency II increased over the year from £0.6m to £1.2m due to the impact of the considerable increase in new business during the year.

C.6 Stress Testing & Scenario Analysis

The Society gives due consideration to the main risk drivers when conducting stress testing. As indicated above, it would generally seek to have sufficient capital to cover market stresses going significantly beyond the amounts specified in the Standard Formula, and would quantify combined adverse price movements in equities and property (and bonds when considered appropriate).

In its FLAOR, the Society would also test the effect of high business volumes. In 2016, the lump sum business written considerably exceeded initial expectations, but such business is considered to be relatively low risk, and the FLAOR had confirmed that the increased risk from higher business volumes was relatively modest.

C.7 Investment Strategy

The Society's investment strategy provides for an appropriate mix of assets to cover the asset shares backing with-profits contracts and for a risk averse asset mix to cover the residual assets. The Society additionally seeks to avoid concentration by adopting pooled funds operated by a number of investment managers, and reputation is a significant factor in choosing such managers. Limits are placed on the maximum proportion of assets in the various pooled funds (none exceeding 10%).

The Society monitors the performance of all its funds, and reports this in regular management information. Such reporting includes monitoring adherence to investment ranges and proportions held in illiquid assets, and in unrated or sub-prime bonds. The Society also regularly reports quantitatively the matching of its assets to its liabilities.

The Society is intending to move from its reliance on pooled funds and appoint an investment manager. The strategy and reporting arrangements will need to adapt, but the underlying principles will remain in place. Whilst the Society does not currently employ directly held derivatives to mitigate risk, it will be open to the appointed manager to propose such a course for us to consider.

C.8 Management Actions

To manage the product risk associated with with-profits contracts, the Society adopts various management actions, all of which are modelled in the technical provisions.

- Annual Bonuses are determined taking into account current long term interest rates, and the extent to which an equity risk premium has been achieved; an allowance is then made for expenses and a final bonus.
- Asset mix is assumed to revert towards target levels over the medium term.
- Charges to asset shares for guarantee costs reflect the recent performance of the equity market and will rise when equity prices are depressed.
- Final bonuses are allowed for by assuming asset share would be the normal payout both for maturity claims, and for surrender and death claims under accumulating with-profits products.
- Market Value Reductions (MVRs) are normally only applied to reduce surrender values below the accumulated sum assured after the Society has met the initial impact of a market fall.

D. VALUATION FOR SOLVENCY PURPOSES

D.1 Assets

The valuation of the Society's assets as at 31 December 2016 are set out below for both solvency purposes (Solvency II) and as underlying the report and accounts (UK GAAP). The only difference between the Solvency II figures and those used to complete the financial statements (UK GAAP) relates to the reinsurers' share of the technical provisions which is currently computed (in the financial statements) on a basis consistent with prior years (Solvency I), and includes intangibles.

Asset Description	**Solvency II value £m**	**UK GAAP value £m**
Liquidity and Bond Funds	72.1	72.1
Equity Funds	41.5	41.5
Insurance Linked Security Funds	2.0	2.0
Property Funds	15.5	15.5
Deposits	1.0	1.0
Cash	4.0	4.0
Reinsurers' Share of Technical Provisions	1.1	2.4
Tangible and Intangible Assets	0.3	0.3
Insurance Receivables	0.4	0.4
Reinsurance Receivables	0.0	0.0
Other Debtors	0.4	0.4
Prepayments and Accrued Income	0.1	0.1
Total	**138.4**	**139.7**

The main bases for determining the value of assets are as follows.

D.1.1 Investments

Units in unit trusts or other pooled fund vehicles are included at published bid prices or single price for single priced funds.

D.1.2 Deferred Taxation

Deferred taxation is provided, in respect of timing differences where there is a reasonable probability that such taxation will become payable. At the balance sheet date there was a net liability for deferred tax of £0.6m.

D.1.3 Tangible and Intangible Assets

Depreciation or amortisation is provided on fixed and intangible assets in order to write off the cost of such assets over their estimated useful lives.

The principal component, £0.2m, relates to the Society's leasehold premises and is depreciated linearly over the outstanding lease term to April 2025.

Intangible assets (software) are expected to generate future economic benefit. The UK GAAP carrying value is reviewed for impairment if events or changes in circumstance indicate the carrying value may not be recoverable. No credit is taken for intangible assets under Solvency II.

D.2 Technical Provisions

The Technical Provisions are determined in line with the regulations set out in Article 77 of the Solvency II Directive[1] and are equal to the sum of the best estimate liabilities ('BEL') and the risk margin ('RM').

D.2.1 Technical Provisions as at 31.12.16

Table D.1 below sets out the segmentation of Metfriendly's business into lines of business for Solvency II purposes. All lines of business are written within a single with-profits fund and no products span more than one line of business.

Table D.1

Metfriendly – Solvency II Lines of Business	
Category	**Description**
Life With-Profits Participation	This includes conventional with-profits savings products and accumulating with-profits products (both tax-exempt and taxable), both legacy business and current product lines.
Other Life Insurance	This includes the 5 year non-profit savings plan and level, decreasing and mortgage protection business and accelerated critical illness business.
Health Insurance	This comprises a small amount of income protection business, which is not considered material, and a small but growing amount of critical illness business.

The technical provisions as at 31.12.16 for each material line of business are given in table D.2 below.

Table D.2

Component (£m)	Line of Business	Solvency II Technical Provisions as at 31.12.16[1] (£ m)	UK GAAP Mathematical Liabilities as at 31.12.16[1] (£ m)
BEL	Life With-Profits Participation	99.9[3]	105.5
	Other Life Insurance	6.8[4]	8.7
	Health Insurance	1.6[4]	1.8
Risk Margin		1.2	n/a
Expense Overrun Reserve		n/a	2.3
Credit Risk Reserve		n/a	0.1
Total TP/ML		109.5	118.4

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0138&from=EN

1. Technical Provisions and mathematical liabilities are gross of reinsurance.
2. The reinsurance asset under Solvency II amounts to £1.1m and the mathematical reserves ceded to reinsurers under Solvency I amounts to £2.4m.
3. The BEL for with-profits business is much higher under Solvency I primarily due to the prudent modelling of the cost of guarantees.
4. The BEL for non-profit business is lower under Solvency II due to the removal of the valuation margins of prudence.

On proportionality grounds, Metfriendly has no plans to calculate the risk margin by line of business, only at the fund level. The Society uses the simplification permitted under Guideline 63[2] to apportion the risk margin to its three lines of business.

D.2.2 Best Estimate Liabilities

The best estimate liabilities are determined as the sum of the mathematical liabilities for the with-profits business and the non-profits protection and savings business and are determined using a cash flow projection model for all lines of business (except the income protection business which is calculated outside the model and is not considered a material component of the Society's business, comprising less than 1.5% of the total BEL).

With-profits best estimate liabilities as at 31 December 2016 are taken as the sum of:

- the asset shares as at 31 December 2016; less
- the present value ('PV') of future charges for the cost of guarantees; plus
- the present value of the cost of those guarantees; less
- the present value of any surrender penalties; less
- the present value of mortality charges, where applicable.

The PV of charges for, and costs of, guarantees are determined from the projected monthly cash flows associated with the with-profits insurance contracts, based on the average of 1,000 investment return simulations with due allowance for expected management actions.

The non-profit best estimate liabilities (with the exception of the small amount of income protection business) are based on a projection of future monthly cashflows, at a policy by policy level, using best estimate experience assumptions for future demographic assumptions (that is without any explicit valuation margins of prudence which were added to meet the regulatory requirements of Solvency I).

The model discounts monthly cashflows using the risk-free interest rate term structure as specified by EIOPA at the valuation date to calculate the BEL; in accordance with Article 77 of the Solvency II Directive.

Projection Basis

Appendix D.1 sets out the basis and assumptions used to determine Metfriendly's Solvency II Technical Provisions as at 31 December 2016.

Mortality Assumptions

Metfriendly's mortality experience is reviewed annually. Both experience over the current valuation year and experience over a rolling four year average is considered for each line of protection business and for the savings business as a whole. Mortality assumptions are set with reference to standard mortality tables, generated by the Continuous Mortality Investigation ('CMI'). These tables are based on industry wide experience for assured lives.

[2] https://eiopa.europa.eu/Publications/Guidelines/TP_Final_document_EN.pdf

Expense Assumptions

In accordance with Article 78, Metfriendly takes into account all expenses that will be incurred in servicing its insurance obligations in setting the best estimate assumptions, namely:

- The cost of maintenance expenses associated with existing insurance obligations
- The cost of investment management expenses associated with existing insurance obligations

Metfriendly analyses its expenses annually, and apportions the non-acquisition expenses between the with-profits, non-profits savings and protection business.

The best estimate allowances for maintenance expenses are derived from this analysis and take the form of a percentage of office premium deduction for the savings products (both with-profits and the non-profit guaranteed 5 year savings plan) and a per policy expense charge for all the non-profit protection lines of business except the income protection, for which an expense allowance of 15% of the ICOP reserve is used. These allowances are netted for tax where appropriate.

These best estimate assumptions are not adjusted in the Solvency II calculations when determining the best estimate liabilities. However, an explicit 25% valuation margin for prudence is applied to the per-policy and per-premium expense assumptions when determining the liabilities for the financial statements.

Investment management expenses are charged monthly to projected with-profits asset shares.

Future acquisition expenses are not included in the cash flow projections, as only the expenses relating to the future management of the existing insurance obligations needs to be considered.

Lapse Assumptions

Metfriendly carries out an annual review of its persistency experience, at a product level. Best estimate lapse assumptions for use in the model to calculate the Solvency II reporting figures are derived from this review having regard to the previous 3 years' experience and allowing for any emerging trends within the data. In determining the liabilities for the financial statements allowance is only made for lapses within the protection business (to which an explicit 25% deduction is applied as a valuation margin of prudence).

Reinsurance

As the reinsurance recoverables are treated as an asset, the best estimate liabilities are determined and reported gross of reinsurance in accordance with Article 77 of the Solvency II Directive. The value of reinsurance recoverables are determined in a manner consistent with that used to calculate the gross best estimate liabilities, using the same model, in line with Article 41 of the Delegated Acts and are included as a separate asset on the Solvency II balance sheet. This figure includes an adjustment for reinsurer counterparty default in accordance with Article 81 of the Solvency II Directive.

D.2.3 Risk Margin

The formula by which the risk margin is to be calculated is set out in Article 37 of the Delegated Acts. It is based on the capital that a party taking over the business would need to establish to support the unavoidable risks that are being taken on, known as non-hedgeable risks.

Metfriendly assumes that all market risks are hedgeable, except the Type 2 equity risk (which relates to certain asset categories, such as insurance-linked securities, for which a full look-through approach cannot be determined), and therefore excludes them from the projected SCR used in the Risk Margin calculation. The non-hedgeable risks for Metfriendly are considered to be the following:-

- Market Risk:
    - Type 2 Equity risk

- Insurance Risks:
    - Mortality Risk
    - Expense Risk
    - Lapse Risk
    - Morbidity Risk
    - Catastrophe Risk

- Counterparty Default Risk

- Operational Risk

The Risk Margin is determined by projecting the Solvency Capital Requirement ('SCR') in respect of the non-hedgeable risks set out above. The SCRs for each non-hedgeable risk are projected assuming the initial value of SCR runs off in line with appropriate risk drivers, making use of the simplified method permitted under Article 58 of the Commission Delegated Regulation (EU) 2015/35. This approach is consistent with Method 1 of the Hierarchy of Simplifications outlined in the Solvency II Guidelines[3].

[3] https://eiopa.europa.eu/Publications/Guidelines/TP_Final_document_EN.pdf

Table D.3 below sets out the risk drivers that are used to project the future SCR based on the initial values by risk module.

Table D.3

Risk	Risk Module	Cap. Req. (£ m)	Projection risk driver
Mortality	Life Underwriting	0.3	Projected death benefit on term assurance business (net of reinsurance) and G5YSP
Expenses	Life Underwriting	0.3	Non-profit: Projected death benefit on term assurance business (net of reinsurance) and G5YSP With-Profits: Asset share in-force
Lapses	Life Underwriting	0.4	Non-profit: Projected death benefit on term assurance business (net of reinsurance) and G5YSP With-Profits: Asset share in-force
Life Catastrophe	Life Underwriting	0.1	Projected death benefit on term assurance business (net of reinsurance) and G5YSP
Type II Equities	Market	0.1	Asset share in-force
Counterparty Default	N/A	0.4	Asset share in-force
Health	Health Underwriting	0.4	Number of policyholders
Operational	Aggregate	1.2	Asset share in-force

D.2.4 Uncertainty in the Technical Provisions

Asset Shares

The asset shares as at 31 December 2016 comprise 91% of the technical provisions, as determined by the Society and are not subject to any material uncertainty in their determination.

Assumptions

A number of scenarios have been considered to illustrate the impact on technical provisions of certain changes in the underlying demographic and economic assumptions as at the valuation date, to highlight that there is a level of uncertainty when setting these assumptions. The results of these investigations indicate that a 10% deterioration in the demographic assumptions for the non-profit business would result in a 5% increase in the net BEL.

Modelling

Further tests have been carried out to assess the sensitivity of the PV of the cost of, and the charge for, the guarantees if full rather than reduced model points are used, and if 5,000 rather than 1,000 investment return simulations are used. This analysis is performed to highlight the level of uncertainty in attempting to model the complexity of estimated future investment returns. The results of these investigations are set out below and show that the difference is not material.

Model Points

The cost of guarantees and charges in the base run using reduced model points ('MP') are compared against a base run using full model points in order to determine the impact of using reduced model points. The results are shown in the tables below.

Comparison of PV Cost of Guarantees			
	Reduced MP (£ m)	**Full MP (£ m)**	**Difference (%)**
CWP	1.28	1.28	+0.01%
AWP	2.50	2.50	+0.04%
Total	3.78	3.78	+0.03%

Comparison of PV Charges			
	Reduced MP (£ m)	**Full MP (£ m)**	**Difference (%)**
CWP	0.47	0.47	-0.16%
AWP	3.27	3.27	+0.22%
Total	3.75	3.74	+0.17%

The differences are considered sufficiently small that results from the reduced model points can be used without adjustment.

Number of Investment Return Simulations

The investment returns are modelled stochastically by using a large number of randomly generated economic scenarios. 1,000 such scenarios are used and to demonstrate that this is sufficiently large the base run using 1,000 scenarios is compared against a run using 5,000 scenarios. The comparison of cost of guarantees is given below.

Comparison of PV Cost of Guarantees			
	1,000 scenarios (£ m)	5,000 scenarios (£ m)	Difference (%)
CWP	1.28	1.27	+0.83%
AWP	2.50	2.48	+0.71%
Total	3.78	3.75	+0.75%

Comparison of PV Cost of Guarantees Charges			
	1000 scenarios (£ m)	5000 scenarios (£ m)	Difference (%)
CWP	0.47	0.47	-0.05%
AWP	3.27	3.28	-0.20%
Total	3.75	3.75	-0.18%

The 5,000 scenario results produce a cost of guarantee that is 0.75% lower than in the 1,000 scenario case. This introduces a level of prudence of low significance into the results when using 1,000 scenarios (compared to using 5,000 scenarios) and demonstrates that using 1,000 scenarios is sufficient for the year-end valuation under Solvency II.

Risk Margin

The sensitivity of the risk margin to changes in the risk drivers and a parallel downward shift in the risk free interest rate curve have been investigated.

These investigations indicate that the risk margin is not particularly sensitive to changes in either the risk free interest rate curve or a change in key risk drivers. For example, a 1% parallel fall in the risk free interest rate curve increases the risk margin by £0.1m, from £1.2m to £1.3m.

The risk margin is most sensitive to changes in the operational risk SCR, which increased as a result of the increase in new business written and accounted for most of the increase in risk margin from £0.9m as at 31 December 2015 to £1.2m as at 31 December 2016.

D.2.5 Difference in Technical Provisions Reported Under Solvency II and Those Published in the Financial Statements

The technical provisions in the financial statements as at 31 December 2016 are determined using the Solvency I basis, methodology and assumptions. The assumptions for the financial statements are derived in line with INSPRU 1.2[4] (the regulations on which Solvency I was based), and where a gross premium valuation is used the demographic assumptions are the same best estimate assumptions used to determine the Solvency II figures but with an additional explicit margin for prudence (usually 25%).

In the financial statements the mathematical liabilities for the accumulating with-profits business have been taken as the face value (sum assured plus accrued bonuses) of the business and for the conventional with-profits business these have been determined using a net premium valuation methodology, with a 93% net premium limit.

The best estimate liabilities for all the non-profit business (with the exception of the small amount of income protection business) are determined by discounting the projected cash flows at the valuation rate of interest and based on the same best estimate assumptions for mortality, morbidity, expenses (and in the case of the non-profit protection business, lapses) with an additional margin for prudence, typically 25%.

For both the with-profits and non-profit business a valuation rate of interest based on the weighted average rate of return achieved on the backing assets, adjusted for expenses, tax, default risk and statutory margin is used, (in line with INSPRU 3.1.28 – 3.1.47), rather than the risk free interest rate curve specified under Solvency II.

For with-profits business an additional Terminal Bonus Reserve is established. The Terminal Bonus Reserve is determined as the difference between the 101% of the asset shares and with-profits reserves (net premium reserve for CWP business and accumulated sum assured for AWP business) including the cost of new bonus, calculated by each line of business. The Terminal Bonus Reserve as at 31 December 2016 is £15.3m.

For the financial statements a separate reserve for the cost of guarantees is also established for the Accumulating With-Profits ('AWP') business. The earlier tranches of this business were written with annual and quinquennial MVR-free guarantees whereas business written since October 2012 only provide a MVR-free guarantee on death.

The cost of guarantees reserve is calculated outside the model using the Black Scholes closed form methodology, by each line of business, rather than being determined stochastically as is the case for the Solvency II investigations. The expected cost of guarantee at a policy anniversary for a single policy is estimated as the cost of a European put option on the asset share as at the valuation date with an exercise price of the guaranteed return of premium and declared bonuses at that policy anniversary. For those later tranches of accumulating with-profits policies written without MVR-free guarantees, guarantee costs for guaranteed death benefits are assessed using the Black-Scholes methodology. The expected cost of the death guarantee in each future policy year is valued as the cost of a put option with an exercise date at the policy anniversary. The total expected cost is then valued as the sum of the expected cost of guarantee in each future policy year allowing for survival to, and subsequent death, in that policy year.

A comparison of the bases used for the Solvency II investigation and the financial statements is given in Appendix D.1.

[4] INSPRU was the PRA's Prudential sourcebook for insurers under the previous Solvency I insurance regime –the last day that INSPRU was in force was 31 December 2015.

Adjustments

As at 31 December 2016, the Society does not make use of any of the following potential adjustments:-

- matching adjustment;
- volatility adjustment;
- transitional provisions on the risk-free interest rate term structure; or,
- transitional measures for technical provisions.

D.2.6 Reinsurance Recoverables

The reinsured amounts have been separately calculated in accordance with Article 81 of the Solvency II Directive. The reinsurance recoverables relate to the non-profit protection business, including the income protection business, and have been determined on a basis consistent with the valuation of the gross liabilities.

D.2.7 Material Changes over the Period

There have been no material changes in assumptions made in the calculation of the technical provisions as at 31 December 2016 compared to those used as at 31 December 2015.

D.3 Other Liabilities

The other liabilities as at 31.12.16 are given in the Table D.4 below.

Table D.4

	Solvency II	**UK GAAP**
Other Liabilities	**£ m**	**£ m**
Deferred Tax Liability	0.6	0.6
Insurance and intermediaries payables	0.4	0.4
Reinsurance payables	0.1	0.1
Payables (trade not insurance)	0.2	0.2
Pension benefit obligations	0.0	0.0
Other (all taxation)	0.4	0.4
TOTAL	1.7	1.7

For the other liabilities set out above, there are no material differences between the valuation basis, methodology and assumptions used for the financial statements and those used for the Solvency II balance sheet.

The deferred tax liability comprises a deferred tax liability of £0.8m in respect of deemed capital gains already incurred which are charged over a 7 year period, and a deferred tax asset of £0.2m in respect of acquisition expenses already incurred which are relieved over a 7 year period.

The taxation liability is substantially in respect of the estimated corporation tax assessed for 2016, due to be paid in 2017.

D.4 Alternative Methods for Valuation

The Society does not make use of any alternative valuation methods.

D.5 Any Other Information

There is no further material information regarding the valuation of assets and liabilities.

APPENDIX D.1 – VALUATION METHODOLOGY AND ASSUMPTIONS

Comparison of Solvency I (prudent) Assumptions with Solvency II (best estimate) Assumptions as at 31.12.2016

The following table sets out the Solvency I prudent assumptions (used in the calculation of the financial statements) and the respective Solvency II best estimate assumptions (used to determine the technical provisions for solvency purposes) for comparison. Under Solvency II the assumptions used to determine the best estimate liabilities ('BEL') no longer contain any valuation margins of prudence.

<table>
<tr><th colspan="2">Assumption category</th><th>Solvency I – 31.12.2016</th><th>Solvency II – 31.12.2016</th></tr>
<tr><td>Discounting</td><td>Valuation Rate of Interest</td><td>1.00% p.a. for non-profit business

0.50% p.a. for with-profits business</td><td>Solvency II yield curve: Risk-free rate calibrated to market swap rates in a given currency with a 0.17% reduction at all terms to reflect credit risk</td></tr>
<tr><td rowspan="2">Decrements</td><td>Mortality</td><td>100% of standard mortality tables:

AMC/AFC00 for with-profit endowment business and G5YSP

TMN/TFN00 for term assurance business (non-smokers)

TMS/TFS00 for term assurance business (smokers)</td><td>80% of standard mortality tables:

AMC/AFC00 for with-profits endowment business and G5YSP

TMN/TFN00 for term assurance business (non-smokers)

TMS/TFS00 for term assurance business (smokers)</td></tr>
<tr><td>Morbidity</td><td>125%/150% of standard morbidity tables (non-smokers/smokers):

CIBT93 M/F with 2% p.a. deterioration rate</td><td>100%/120% of standard morbidity tables (non-smokers/smokers):

CIBT93 M/F with 2% p.a. deterioration rate</td></tr>
</table>

	Lapses	Only applied to term assurance business (DTA, LTA, Table 17 and Table 23). Level Term Assurances: 2.25% p.a. Decreasing Term Assurances: 3.75% p.a. policy years 1-2 5.25% p.a. policy years 3+ No equivalent allowance for lapses for Tables 8, 10, 11, 12, 14, 15, 16, 19, 21, 22, 24, 25, 26, 27, 28, 29 and 30 under Solvency I, as none of these products are term assurance business.	Lapse rates assumed for all business. In particular: Level Term Assurances: 3.00% p.a. Decreasing Term Assurances: 5.00% p.a. policy years 1-2 7.00% p.a. policy years 3+ 5 year savings plan: 5.00% p.a. at all durations, except 3% final policy year Table 8: 2.00% p.a. Table 10: 1.00% p.a. Table 11: 4.00% p.a. Table 21: 4.00% p.a. Table 22: 4.00% p.a. Table 12: 5.00% p.a. years 1-5 2.00% p.a. years 6+ Table 14: 4.00% p.a. at all durations, except 3% final policy year Tables 15/16: 5.00% p.a. policy years 1-5 2% p.a. policy years 6+ Table 19: 8.00% p.a. Table 24: 5.00% p.a. Table 25: 12.00% p.a. Table 26: 8.00% p.a. Table 27: 12.00% p.a. Table 28: 0.00% p,a. Table 29: 12.00% p.a. Table 30: 0.00% p.a.
Expenses	Per Policy (term assurances)	£50.00 p.a.	£40.00 p.a.
	Per Premium (AWP, CWP and G5YSP)	6.875% (G5YSP only)	5.500%
	Asset Shares	1.00% p.a.	1.00% p.a.
	Expense Inflation	3.50% p.a.	3.00% p.a.

E. Capital Management

E.1 Own Funds

The Society's Own Funds arise entirely from historical surpluses which have not been distributed to members. As such the capital is all Tier 1 and there are no restrictions on the availability of those funds to support the MCR or SCR. The Society expects its Own Funds to remain sufficient to cover the SCR and plans its business accordingly – there is no intention to raise capital by other means.

The Own Funds have been quantified as total assets less technical provisions and other liabilities. For Solvency II reporting this amounts to £27.2m. This compares to the equity (Fund for Future Appropriations) shown in the Report and Accounts of £19.6m. The difference relates to the margins for prudence employed in the Report and Accounts which reflect the requirements of the Solvency I regime. In particular, when reserving for the cost of future guarantees under Solvency I:

- no allowance is made for lapses, and
- no credit is taken for the charges levied to meet these costs.

As noted under "Business and Performance", the Fund for Future Appropriations reduced over 2016 by £2.5m. A significant component of this relates to the cost of future guarantees, given the volume of single premium business written. On a Solvency II basis, which will underlie future calculations, the Own Funds increased by £0.7m. The material contributory factor to this marginal increase in Own Funds was strong investment returns largely offset by:

- falls in yields;
- a distribution of excess surplus at a cost of £1.0m; and,
- new business strain.

E.2 Solvency Capital Requirement and Minimum Capital Requirement

E.2.1 Solvency Capital Requirement ('SCR') and Minimum Capital Requirement ('MCR')

The SCR and MCR as at 31 December 2016 amount to £8.3m and £3.3m, respectively. The amount of the SCR split by risk module, before any diversification benefit is applied between risk modules, is shown in Table E.1 below.

Table E.1

Risk Module		SCR £m
Market Risk		6.7
Life Insurance Risk		0.8
Health Insurance Risk		0.4
Counterparty Risk		0.4
Operational Risk		1.2

Metfriendly uses the Standard Formula to determine its Solvency Capital Requirement, it does not make use of any company specific parameters or undertaking specific parameters.

The PRA has granted Metfriendly quarterly reporting exemptions with effect from 1 January 2016 until 1 January 2021. Table E.2 below sets out the amounts of the SCR and MCR as reported to the PRA.

Table E.2

Date		SCR £m	MCR £m	Linear MCR biting?
Day 1		7.7*	2.7	Linear MCR
Year End 2016		8.3	3.3	MCR – absolute floor

* The Day 1 SCR figure has been restated (previously £7.2m) to reflect modelling improvements incorporated as part of the 2016 year-end investigations.

The material change in the MCR during the year is due to the increase in the Euro exchange rate used to set the absolute floor for the MCR.

The change in the SCR during 2016 primarily relates to the impact of writing significantly higher volumes of new business during 2016 including a consequential increase to the operational risk capital requirement. There was an increase to the SCR of £0.5m due to modelling improvements relating to the investment expenses and the expenses allowances in the market stresses. The Day 1 figures have been restated to allow for these improvements, resulting in a similar increase to the SCR of £0.5m. There was no change to the MCR.

E.2.2 Simplifications

The following simplifications are used in the standard formula when determining the Society's SCR:

Income Protection

The income protection business comprises less than 1.5% of the total technical provisions (including the risk margin) and is currently not actively marketed, such that the number of policyholders in force has been in a gradual decline for some years. As such, it is considered appropriate, given the nature, scale and complexity of this business to determine the approximate level of capital under the 1-in-200 morbidity stress as 100% of the annual premium for the in force business. This amounts to £0.3m as at 31 December 2016.

Deferred Tax Assets

Metfriendly considers a deferred tax asset of up to 2% of taxable assets is appropriate, so long as this is not otherwise felt to be impaired. The position is reviewed annually and following any major movement in the markets. It was reviewed as part of the Day 1 Solvency II process, with Management concluding it remains an appropriate position to take. This amounts to £0.8m (based on year-end 2016 asset shares) and is then reduced by any DTA already on the Society's balance sheet as at the valuation date (£0.3m as at 31 December 2016), giving a figure of £0.5m, which has been used as the limit in the year-end 2016 Solvency II calculations following a market stress.

The actuarial model used to project the cash flows allows appropriately for a deferred tax benefit following a market stress, so a manual addition is made to the capital requirement to reflect the Society's internal limit, based on the level of any deferred tax asset that it considers recoverable.

The additional capital requirement is determined as the proportion of the asset shock that transmits into guarantee costs for that part of the deferred tax benefit that is not deemed to be recoverable. This capital is then allocated proportionately to the relevant risk sub-modules (undiversified capital for individual risks). This additional capital requirement amounted to £0.4m as at 31 December 2016.

Smoothing

Metfriendly holds additional capital to reflect an unmodelled management action, whereby the terminal bonus attributed to the 5 year with-profits plan will not be reduced below 4% in the event of a 1-in-200 market risk event. This results in an additional capital requirement of £0.4m (post diversification in the market risk module) as at 31 December 2016. This capital amount is apportioned to the individual market stresses before diversification such that it amounts to £0.4 m after diversification in the market risk module, in line with the requirement under Solvency II to allocate all required capital at the undiversified risk level.

Table 14 contracts are no longer written and the final policy will have matured by 31 December 2018. This manual addition to capital is expected to reduce to 0 during the next 2 years in a broadly linear manner.

E.3 Use of Duration Based Equity Risk Sub-Module

Metfriendly does not use a duration based equity risk sub-module in the calculation of the SCR.

E.4 Internal Model Information

Metfriendly does not use an internal model for determining its SCR.

E.5 Non-Compliance with the MCR or SCR

Metfriendly has a MCR coverage ratio of 824% and an SCR coverage ratio of 327% as at 31 December 2016 and is financially strong. It has complied with the both the Minimum Capital Requirement and the Solvency Capital Requirement throughout 2016 by a large margin.

Metropolitan Police Friendly Society

Solvency and Financial Condition Report

Disclosures

31 December

2016

(Monetary amounts in GBP thousands)

General information

Undertaking name	Metropolitan Police Friendly Society
Undertaking identification code	2138004FK1A956D5KT97
Type of code of undertaking	LEI
Type of undertaking	Life undertakings
Country of authorisation	GB
Language of reporting	en
Reporting reference date	31 December 2016
Currency used for reporting	GBP
Accounting standards	The undertaking is using local GAAP (other than IFRS)
Method of Calculation of the SCR	Standard formula
Matching adjustment	No use of matching adjustment
Volatility adjustment	No use of volatility adjustment
Transitional measure on the risk-free interest rate	No use of transitional measure on the risk-free interest rate
Transitional measure on technical provisions	No use of transitional measure on technical provisions

List of reported templates

S.02.01.02 - Balance sheet
S.05.01.02 - Premiums, claims and expenses by line of business
S.05.02.01 - Premiums, claims and expenses by country
S.12.01.02 - Life and Health SLT Technical Provisions
S.23.01.01 - Own Funds
S.25.01.21 - Solvency Capital Requirement - for undertakings on Standard Formula
S.28.01.01 - Minimum Capital Requirement - Only life or only non-life insurance or reinsurance activity

S.02.01.02

Balance sheet

		Solvency II value
	Assets	C0010
R0030	Intangible assets	0
R0040	Deferred tax assets	0
R0050	Pension benefit surplus	0
R0060	Property, plant & equipment held for own use	226
R0070	Investments (other than assets held for index-linked and unit-linked contracts)	132,138
R0080	*Property (other than for own use)*	0
R0090	*Holdings in related undertakings, including participations*	0
R0100	*Equities*	0
R0110	*Equities - listed*	0
R0120	*Equities - unlisted*	0
R0130	*Bonds*	0
R0140	*Government Bonds*	0
R0150	*Corporate Bonds*	0
R0160	*Structured notes*	0
R0170	*Collateralised securities*	0
R0180	*Collective Investments Undertakings*	129,151
R0190	*Derivatives*	0
R0200	*Deposits other than cash equivalents*	1,014
R0210	*Other investments*	1,974
R0220	Assets held for index-linked and unit-linked contracts	0
R0230	Loans and mortgages	0
R0240	*Loans on policies*	0
R0250	*Loans and mortgages to individuals*	0
R0260	*Other loans and mortgages*	0
R0270	Reinsurance recoverables from:	1,127
R0280	*Non-life and health similar to non-life*	0
R0290	*Non-life excluding health*	0
R0300	*Health similar to non-life*	0
R0310	*Life and health similar to life, excluding index-linked and unit-linked*	1,127
R0320	*Health similar to life*	281
R0330	*Life excluding health and index-linked and unit-linked*	847
R0340	*Life index-linked and unit-linked*	0
R0350	Deposits to cedants	0
R0360	Insurance and intermediaries receivables	418
R0370	Reinsurance receivables	28
R0380	Receivables (trade, not insurance)	397
R0390	Own shares (held directly)	0
R0400	Amounts due in respect of own fund items or initial fund called up but not yet paid in	0
R0410	Cash and cash equivalents	4,004
R0420	Any other assets, not elsewhere shown	61
R0500	**Total assets**	138,400

S.02.01.02

Balance sheet

		Solvency II value
	Liabilities	C0010
R0510	Technical provisions - non-life	0
R0520	*Technical provisions - non-life (excluding health)*	0
R0530	*TP calculated as a whole*	0
R0540	*Best Estimate*	0
R0550	*Risk margin*	0
R0560	*Technical provisions - health (similar to non-life)*	0
R0570	*TP calculated as a whole*	0
R0580	*Best Estimate*	0
R0590	*Risk margin*	0
R0600	Technical provisions - life (excluding index-linked and unit-linked)	109,527
R0610	*Technical provisions - health (similar to life)*	1,805
R0620	*TP calculated as a whole*	0
R0630	*Best Estimate*	1,623
R0640	*Risk margin*	182
R0650	*Technical provisions - life (excluding health and index-linked and unit-linked)*	107,721
R0660	*TP calculated as a whole*	0
R0670	*Best Estimate*	106,691
R0680	*Risk margin*	1,031
R0690	Technical provisions - index-linked and unit-linked	0
R0700	*TP calculated as a whole*	0
R0710	*Best Estimate*	0
R0720	*Risk margin*	0
R0740	Contingent liabilities	0
R0750	Provisions other than technical provisions	0
R0760	Pension benefit obligations	33
R0770	Deposits from reinsurers	0
R0780	Deferred tax liabilities	546
R0790	Derivatives	0
R0800	Debts owed to credit institutions	0
R0810	Financial liabilities other than debts owed to credit institutions	0
R0820	Insurance & intermediaries payables	368
R0830	Reinsurance payables	106
R0840	Payables (trade, not insurance)	61
R0850	Subordinated liabilities	0
R0860	*Subordinated liabilities not in BOF*	0
R0870	*Subordinated liabilities in BOF*	0
R0880	Any other liabilities, not elsewhere shown	577
R0900	**Total liabilities**	111,217
R1000	**Excess of assets over liabilities**	27,183

S.05.01.02

Premiums, claims and expenses by line of business

Life

		Line of Business for: life insurance obligations						Life reinsurance obligations		Total
		Health insurance	Insurance with profit participation	Index-linked and unit-linked insurance	Other life insurance	Annuities stemming from non-life insurance contracts and relating to health insurance obligations	Annuities stemming from non-life insurance contracts and relating to insurance obligations other than health insurance obligations	Health reinsurance	Life reinsurance	
		C0210	C0220	C0230	C0240	C0250	C0260	C0270	C0280	C0300
	Premiums written									
R1410	Gross	327	20,722		3,345					24,394
R1420	Reinsurers' share	42	0		391					433
R1500	Net	285	20,722		2,954					23,961
	Premiums earned									
R1510	Gross	327	20,722		3,345					24,394
R1520	Reinsurers' share	42	0		391					433
R1600	Net	285	20,722		2,954					23,961
	Claims incurred									
R1610	Gross	114	12,307		622					13,044
R1620	Reinsurers' share	21	0		297					318
R1700	Net	94	12,307		325					12,726
	Changes in other technical provisions									
R1710	Gross	0	0		0					0
R1720	Reinsurers' share	0	0		0					0
R1800	Net	0	0		0					0
R1900	**Expenses incurred**	99	1,981		336					2,416
R2500	**Other expenses**									
R2600	**Total expenses**									2,416

S.05.02.01

Premiums, claims and expenses by country

Life

		C0150	C0160	C0170	C0180	C0190	C0200	C0210
R1400		Home Country	Top 5 countries (by amount of gross premiums written) - life obligations			Top 5 countries (by amount of gross premiums written) - life obligations		Total Top 5 and home country
		C0220	C0230	C0240	C0250	C0260	C0270	C0280
	Premiums written							
R1410	Gross	24,394	0	0	0	0	0	24,394
R1420	Reinsurers' share	433	0	0	0	0	0	433
R1500	Net	23,961	0	0	0	0	0	23,961
	Premiums earned							
R1510	Gross	24,394	0	0	0	0	0	24,394
R1520	Reinsurers' share	433	0	0	0	0	0	433
R1600	Net	23,961	0	0	0	0	0	23,961
	Claims incurred							
R1610	Gross	13,044	0	0	0	0	0	13,044
R1620	Reinsurers' share	318	0	0	0	0	0	318
R1700	Net	12,726	0	0	0	0	0	12,726
	Changes in other technical provisions							
R1710	Gross	0	0	0	0	0	0	0
R1720	Reinsurers' share	0	0	0	0	0	0	0
R1800	Net	0	0	0	0	0	0	0
R1900	**Expenses incurred**	2,416	0	0	0	0	0	2,416
R2500	**Other expenses**							0
R2600	**Total expenses**							2,416

S.12.01.02

Life and Health SLT Technical Provisions

			Index-linked and unit-linked insurance			Other life insurance						Health insurance (direct business)					
		Insurance with profit participation		Contracts without options and guarantees	Contracts with options or guarantees		Contracts without options and guarantees	Contracts with options or guarantees	Annuities stemming from non-life insurance contracts and relating to insurance obligation other than health insurance obligations	Accepted reinsurance	Total (Life other than health insurance, including Unit-Linked)		Contracts without options and guarantees	Contracts with options or guarantees	Annuities stemming from non-life insurance contracts and relating to health insurance obligations	Health reinsurance (reinsurance accepted)	Total (Health similar to life insurance)
		C0020	C0030	C0040	C0050	C0060	C0070	C0080	C0090	C0100	C0150	C0160	C0170	C0180	C0190	C0200	C0210
R0010	**Technical provisions calculated as a whole**	0				0					0	0					0
R0020	Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default associated to TP calculated as a whole	0				0					0	0					0
	Technical provisions calculated as a sum of BE and RM																
	Best estimate																
R0030	**Gross Best Estimate**	99,895					1,352	5,443			106,691		1,623	0			1,623
R0080	Total Recoverables from reinsurance/SPV and Finite Re after the adjustment for expected losses due to counterparty default	0					847	0			847		281	0			281
R0090	Best estimate minus recoverables from reinsurance/SPV and Finite Re	99,895					505	5,443			105,844		1,343	0			1,343
R0100	**Risk margin**	870				161					1,031	182					182
	Amount of the transitional on Technical Provisions																
R0110	Technical Provisions calculated as a whole	0				0					0	0					0
R0120	Best estimate	0					0	0			0		0	0			0
R0130	Risk margin	0				0					0	0					0
R0200	**Technical provisions - total**	100,765				6,956					107,721	1,805					1,805

S.23.01.01

Own Funds

	Basic own funds before deduction for participations in other financial sector as foreseen in article 68 of Delegated Regulation 2015/35	Total	Tier 1 unrestricted	Tier 1 restricted	Tier 2	Tier 3
		C0010	C0020	C0030	C0040	C0050
R0010	Ordinary share capital (gross of own shares)	0	0		0	
R0030	Share premium account related to ordinary share capital	0	0		0	
R0040	Initial funds, members' contributions or the equivalent basic own-fund item for mutual and mutual-type undertakings	0	0		0	
R0050	Subordinated mutual member accounts	0		0	0	0
R0070	Surplus funds	19,617	19,617			
R0090	Preference shares	0		0	0	0
R0110	Share premium account related to preference shares	0		0	0	0
R0130	Reconciliation reserve	7,566	7,566			
R0140	Subordinated liabilities	0		0	0	0
R0160	An amount equal to the value of net deferred tax assets	0				0
R0180	Other own fund items approved by the supervisory authority as basic own funds not specified above	0	0	0	0	0
R0220	**Own funds from the financial statements that should not be represented by the reconciliation reserve and do not meet the criteria to be classified as Solvency II own funds**	0				
R0230	**Deductions for participations in financial and credit institutions**	0	0	0	0	0
R0290	**Total basic own funds after deductions**	27,183	27,183	0	0	0
	Ancillary own funds					
R0300	Unpaid and uncalled ordinary share capital callable on demand	0			0	
R0310	Unpaid and uncalled initial funds, members' contributions or the equivalent basic own fund item for mutual and mutual - type undertakings, callable on demand	0			0	
R0320	Unpaid and uncalled preference shares callable on demand	0			0	0
R0330	A legally binding commitment to subscribe and pay for subordinated liabilities on demand	0			0	0
R0340	Letters of credit and guarantees under Article 96(2) of the Directive 2009/138/EC	0			0	
R0350	Letters of credit and guarantees other than under Article 96(2) of the Directive 2009/138/EC	0			0	0
R0360	Supplementary members calls under first subparagraph of Article 96(3) of the Directive 2009/138/EC	0			0	
R0370	Supplementary members calls - other than under first subparagraph of Article 96(3) of the Directive 2009/138/EC	0			0	0
R0390	Other ancillary own funds	0			0	0
R0400	**Total ancillary own funds**	0			0	0
	Available and eligible own funds					
R0500	Total available own funds to meet the SCR	27,183	27,183	0	0	0
R0510	Total available own funds to meet the MCR	27,183	27,183	0	0	
R0540	Total eligible own funds to meet the SCR	27,183	27,183	0	0	0
R0550	Total eligible own funds to meet the MCR	27,183	27,183	0	0	
R0580	**SCR**	8,307				
R0600	**MCR**	3,332				
R0620	**Ratio of Eligible own funds to SCR**	327.23%				
R0640	**Ratio of Eligible own funds to MCR**	815.85%				

	Reconcilliation reserve	C0060
R0700	Excess of assets over liabilities	27,183
R0710	Own shares (held directly and indirectly)	0
R0720	Foreseeable dividends, distributions and charges	0
R0730	Other basic own fund items	19,617
R0740	Adjustment for restricted own fund items in respect of matching adjustment portfolios and ring fenced funds	0
R0760	**Reconciliation reserve**	7,566
	Expected profits	
R0770	Expected profits included in future premiums (EPIFP) - Life business	82
R0780	Expected profits included in future premiums (EPIFP) - Non- life business	0
R0790	**Total Expected profits included in future premiums (EPIFP)**	82

S.25.01.21

Solvency Capital Requirement - for undertakings on Standard Formula

		Gross solvency capital requirement	USP	Simplifications
		C0110	C0080	C0090
R0010	Market risk	11,823		
R0020	Counterparty default risk	404		
R0030	Life underwriting risk	1,392		
R0040	Health underwriting risk	352		
R0050	Non-life underwriting risk	0		
R0060	Diversification	-1,509		
R0070	Intangible asset risk	0		
R0100	**Basic Solvency Capital Requirement**	12,462		

	Calculation of Solvency Capital Requirement	C0100
R0130	Operational risk	1,173
R0140	Loss-absorbing capacity of technical provisions	-5,328
R0150	Loss-absorbing capacity of deferred taxes	0
R0160	Capital requirement for business operated in accordance with Art. 4 of Directive 2003/41/EC	0
R0200	**Solvency Capital Requirement excluding capital add-on**	8,307
R0210	Capital add-ons already set	0
R0220	**Solvency capital requirement**	8,307
	Other information on SCR	
R0400	Capital requirement for duration-based equity risk sub-module	0
R0410	Total amount of Notional Solvency Capital Requirements for remaining part	0
R0420	Total amount of Notional Solvency Capital Requirements for ring fenced funds	0
R0430	Total amount of Notional Solvency Capital Requirements for matching adjustment portfolios	0
R0440	Diversification effects due to RFF nSCR aggregation for article 304	0

S.28.01.01

Minimum Capital Requirement - Only life or only non-life insurance or reinsurance activity

	Linear formula component for non-life insurance and reinsurance obligations	C0010
R0010	MCR_{NL} Result	0

		Net (of reinsurance/SPV) best estimate and TP calculated as a whole	Net (of reinsurance) written premiums in the last 12 months
		C0020	C0030
R0020	Medical expense insurance and proportional reinsurance	0	0
R0030	Income protection insurance and proportional reinsurance	0	0
R0040	Workers' compensation insurance and proportional reinsurance	0	0
R0050	Motor vehicle liability insurance and proportional reinsurance	0	0
R0060	Other motor insurance and proportional reinsurance	0	0
R0070	Marine, aviation and transport insurance and proportional reinsurance	0	0
R0080	Fire and other damage to property insurance and proportional reinsurance	0	0
R0090	General liability insurance and proportional reinsurance	0	0
R0100	Credit and suretyship insurance and proportional reinsurance	0	0
R0110	Legal expenses insurance and proportional reinsurance	0	0
R0120	Assistance and proportional reinsurance	0	0
R0130	Miscellaneous financial loss insurance and proportional reinsurance	0	0
R0140	Non-proportional health reinsurance	0	0
R0150	Non-proportional casualty reinsurance	0	0
R0160	Non-proportional marine, aviation and transport reinsurance	0	0
R0170	Non-proportional property reinsurance	0	0

	Linear formula component for life insurance and reinsurance obligations	C0040
R0200	MCR_L Result	3,283

		Net (of reinsurance/SPV) best estimate and TP calculated as a whole	Net (of reinsurance/SPV) total capital at risk
		C0050	C0060
R0210	Obligations with profit participation - guaranteed benefits	93,037	
R0220	Obligations with profit participation - future discretionary benefits	6,859	
R0230	Index-linked and unit-linked insurance obligations	0	
R0240	Other life (re)insurance and health (re)insurance obligations	7,291	
R0250	Total capital at risk for all life (re)insurance obligations		62,916

	Overall MCR calculation	C0070
R0300	Linear MCR	3,283
R0310	SCR	8,307
R0320	MCR cap	3,738
R0330	MCR floor	2,077
R0340	Combined MCR	3,283
R0350	Absolute floor of the MCR	3,332
R0400	**Minimum Capital Requirement**	3,332