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**Standard Life Assurance Limited**

**and**

**Standard Life Investment Funds Limited**

**Report of the Independent Expert on the terms of the proposed Insurance  
Business Transfer Scheme**

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## Summary of acronyms

Each of these acronyms is defined when first used in the Scheme Report.

AFH	Actuarial Function Holder
BAS	Board for Actuarial Standards
BCRR	Base Capital Resource Requirement
COBS	Conduct of Business Sourcebook (part of the FSA Handbook)
CRR	Capital Resources Requirement
ECR	Enhanced Capital Requirement
EFM	External Fund Manager
FSA	Financial Services Authority (or any successor body)
FSA Handbook	FSA Handbook of Rules and Guidance
FSMA	Financial Services and Markets Act 2000
GSWPF	German Smoothed Managed With-Profits Fund
GWPF	German With-Profits Fund
HWPF	Heritage With-Profits Fund of SLAL
ICA	Individual Capital Assessment
ICG	Individual Capital Guidance
ICRR	Individual Capital Resource Requirement
IGR	Intra-Group Reinsurance
IMAP	Internal Model Approval Process
LTBF	Long Term Business Fund
LTICR	Long Term Insurance Capital Requirement
MCR	Minimum Capital Requirement
ORSA	Own Risk and Solvency Assessment
PBF	Proprietary Business Fund of SLAL
PPFM	Principles and Practices of Financial Management
PRE	Policyholders' Reasonable Expectations
QIS 5	Fifth quantitative impact survey
RCF	Recourse Cash Flow
RCM	Risk Capital Margin

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RCR	Resilience Capital Requirement
ROI	the Republic of Ireland
SHF	Shareholder Fund
SIPP	Self-Invested Pension Plan
SL	Standard Life plc
SLAC	The Standard Life Assurance Company
SLAL	Standard Life Assurance Ltd
SLI	Standard Life Investments Ltd
SLIF	Standard Life Investment Funds Ltd
SLPF	Standard Life Pension Funds Ltd
SUP18	Supervision Manual, Section 18 (of the FSA Handbook)
TAS	Technical Actuarial Standard
TAS-D	Technical Actuarial Standard – Data
TAS-M	Technical Actuarial Standard – Modeling
TAS-R	Technical Actuarial Standard – Reporting
TCF	Treating Customers Fairly
TIP	Trustee Investment Plan
UKSWPF	UK Smoothed Managed With-Profits Fund
WPA	With-Profits Actuary
WPBR	With-Profits Benefit Reserve
WPC	With-Profits Committee
WPICC	With-Profits Insurance Capital Component

## 1. INTRODUCTION

### Instructions

- 1.1 I have been instructed by Standard Life Assurance Limited (“SLAL”) and Standard Life Investment Funds Limited (“SLIF”), to report pursuant to Section 109 of the Financial Services and Markets Act 2000 (“FSMA”) (as amended from time to time) in the capacity of Independent Expert on the terms of the scheme for the proposed transfer of the insurance business of SLIF to SLAL. Standard Life plc (“SL”) is the ultimate parent company of both SLAL and SLIF.
- 1.2 I have also been instructed by SLAL to report on any consequential amendments pursuant to the proposed transfer to the Court approved scheme by which The Standard Life Assurance Company (“SLAC”) demutualised in 2006 (“the 2006 Scheme”) and which applies to the management arrangements of SLAL.

### Scheme of Transfer

- 1.3 The scheme of transfer will be presented to the Court of Session for sanction under Section 111 of FSMA and for incidental matters under section 112.
- 1.4 Throughout the remainder of this report, the term “the Scheme” is used to cover all the proposals included in the scheme of transfer, including any documents referred to therein relating to the proposed implementation and operation of the scheme of transfer.
- 1.5 The Court will also be requested to approve certain technical consequential amendments to the 2006 Scheme.

### Purpose of Report

#### Scope

- 1.6 My appointment as the Independent Expert has been approved by the Financial Services Authority (“FSA”) which has also approved the form of my report (the “Scheme Report”). The Scheme Report has been prepared in compliance with applicable rules on expert evidence. My terms of reference, which include rules on expert evidence, are set out in Appendix 1. I have interpreted my instructions and terms of reference to require me to consider primarily the likely effects of the Scheme on the policyholders of SLAL and SLIF.
- 1.7 In preparing the Scheme Report, I have had regard to the equity of the proposals amongst the various groups of policyholders (reflecting the varying nature of the contractual rights which policyholders have, the operation of their policies and the jurisdiction in which the contract was entered into), the security of the benefits in each company both before and after the implementation of the Scheme, the policyholders' reasonable expectations created by the past practices employed or statements made by SLAL and SLIF, and more generally, the fairness of the proposals insofar as they affect the treatment of policyholders.
- 1.8 In assessing the impact of the Scheme on the security of benefits and on policyholders' reasonable expectations, and whether those policyholders are being treated fairly in the implementation of the Scheme, I have had regard to the reports of the With-Profits Actuary (“WPA”) of SLAL and the Actuarial Function Holder (“AFH”) of SLAL and SLIF on the Scheme.
- 1.9 As far as I am aware, there are no matters which I have not taken into account in undertaking my assessment of the Scheme and in preparing the Scheme Report but which nonetheless should be drawn to the attention of policyholders in their consideration of the terms of the Scheme.
- 1.10 I have also reviewed and considered the communication policy being adopted and the contents of the documents describing the proposals which, subject to the waivers sought being granted by the Court, will be despatched to the holders of SLIF long term policies. An advanced draft of the communication was available to me at the date of the Scheme Report.

- 1.11 The Scheme Report has been prepared under the terms of the guidance contained in Section 18 of the Supervision Manual ("SUP18") contained in the FSA Handbook of Rules and Guidance (the "FSA Handbook") to cover scheme reports relating to transfers of long term insurance business.
- 1.12 A new Technical Actuarial Standard ("TAS"): Transformations ("Transformations TAS") issued by the Board for Actuarial Standards ("BAS") came into force as at 1 October 2011 and applies to scheme reports issued after that date. In my opinion, the Scheme Report complies with the Transformations TAS and is compliant with those elements of the Technical Actuarial Standards on Data, Modelling, Reporting and Insurance ("TAS-D", "TAS-M", "TAS-R" and the "Insurance TAS", respectively) which are applicable to transformations. In complying with these requirements, I note that a number of the key documents listed in 1.27 which I have considered have been prepared or reviewed by individuals who have been subject to professional standards in undertaking their work, including, where appropriate, TAS requirements.

### Qualifications and Disclosures

- 1.13 I am a Fellow of the Institute and Faculty of Actuaries, and have been so since 1980.
- 1.14 I am a Principal of Milliman, Consultants and Actuaries, ("Milliman") based in its London office. I have more than 35 years' experience in the UK life insurance industry, including experience as an Actuarial Function Holder and as an Appointed Actuary, and have acted previously in the capacity of an independent expert under the terms of FSMA, and as an independent actuary under the Insurance Companies Act 1982, the legislation replaced by FSMA.
- 1.15 I have not undertaken any other assignments on behalf of SLAL or SLIF or any other of its subsidiaries in the last 5 years. However, I was closely involved in the preparation of the scheme report in respect of the 2006 Scheme, the review of which was undertaken by a former colleague at Milliman. I am not a policyholder of SLAL or SLIF, nor do I have any other financial interests in SLAL, SLIF or SL.
- 1.16 Milliman is a global consulting firm and has undertaken a number of assignments on behalf of SL or its subsidiary companies over the last 5 years. The scale and nature of the work undertaken globally has been disclosed to the FSA in approving my appointment as the Independent Expert. In particular, I note that one of my colleagues acts as an independent actuarial adviser to SLAL's With-Profits Committee which will also be consulted on the terms of the Scheme.
- 1.17 I do not believe that these other assignments prejudice my independence in reviewing this transfer.

### Structure of the Scheme Report

- 1.18 In Section 2 of the Scheme Report, I discuss the current structure, operations and financial condition of each of SLAL and SLIF and identify the similarities and differences in these which may influence the circumstances of policyholders if the Scheme becomes effective.
- 1.19 In Section 3, I set out my understanding of the proposed Scheme.
- 1.20 In Section 4, I set out my assessment of the terms of the Scheme and its implications for the security of the benefits of the policyholders of SLAL and SLIF and their benefit expectations.
- 1.21 In Section 5, I summarise my conclusions.
- 1.22 In Section 6, I summarise my conclusions on the changes to be made to the 2006 Scheme and set out my certificate regarding the effects of those changes.
- 1.23 In Section 7, I set out my declaration of truth as an expert witness.
- 1.24 Appendix 1 shows the agreed terms of reference for my review.
- 1.25 Appendix 2 contains details of the latest SLAL Pillar 1, Peak 2 financial position which I have considered when undertaking the review.
- 1.26 Appendices 3 and 4 set out a summary of the current prudential regulatory requirements and the proposed new regime of Solvency II. (The summaries shown there apply equally to SLAL and SLIF, as long term insurance companies.)

## Reliances and limitations

1.27 In preparing this report, the principal documents and other information which I have reviewed are:

### Public documents

- SLAL and SLIF Annual Report for 2010;
- SLAL and SLIF Returns to the FSA for 2010;
- Principles and Practices of Financial Management (“PPFM”) for SLAL with-profits fund;
- The scheme and actuarial reports relating to the 2006 Scheme; and,
- The Scheme and the communications to be sent to policyholders and the actuarial reports submitted in respect of the Scheme by the AFH of SLAL and SLIF (the “AFH Report”) and SLAL’s WPA.

### Internal documents

- Recent correspondence between SLAL or SLIF and the FSA;
- Recommendations and Report on the Actuarial Valuations for each of SLAL and SLIF for 2010 produced by its AFH;
- Individual Capital Assessment (“ICA”) for SLAL and SLIF as at 31 December 2010;
- Solvency II Internal Model Application Process (“IMAP”) documents;
- Estimated figures for effect of Solvency II on SLAL and SLIF;
- Capital Management Policy and Risk Appetite Framework adopted by SL; and,
- Reinsurance Agreements and the Security Charge documents.

1.28 I have been given free access to additional documentary evidence held by SLAL and SLIF as requested by me to allow me to investigate all aspects of the Scheme. In addition, I have had access to and discussions with management and their professional advisers to assist in the completion of this report. I have relied on the accuracy of the information which has been provided to me, and have not verified it independently. I have considered, and am satisfied with, the reasonableness of this information from my own experience in the insurance industry.

1.29 This report, and any extract or summary thereof, has been prepared particularly for the use of the bodies or persons listed below:

- the Court;
- the directors of SLAL and SLIF;
- the FSA or any other governmental department or agency having responsibility for the regulation of insurance companies in the UK, and to the extent necessary, the insurance regulator of any EEA country who requests a copy of my report; and,
- the professional advisers of any of the above.

1.30 Copies of this report may be made available for inspection by policyholders, either in physical form or on SL’s website and may be provided to any person requesting the same in accordance with legal requirements. I will provide a summary of this report to be made available to policyholders.

1.31 Neither my report nor any extract from it may be published without my specific written consent having been given, save as set out in section 1.30. In addition, no summary of this report may be made without my express consent.

1.32 This report has been prepared within the context of the assessment of the terms of the Scheme. No liability will be accepted for any application of this report to a purpose for which it was not intended or for the results of any misunderstanding by any user of any aspect of this report. In particular, no liability will be accepted under the terms of the Contracts (Rights of Third Parties) Act 1999.

1.33 Nothing contained in this report should be taken as investment advice, either regarding the products of SLAL or SLIF, the products of any companies in the Standard Life Group ("SL Group"), or any financial instruments issued by them.

1.34 I am available to assist any of the parties listed in 1.29 above in interpreting this report.

## 2. BACKGROUND

### Motivation for the Scheme

- 2.1 The development of the proposed Scheme has arisen from consideration of the suitability of the current structure and operational arrangements of SLAL and its subsidiaries in the light of the impending implementation of a new EU wide regulatory regime for insurance firms ("Solvency II"). The Scheme aims to streamline the operational structure and to create a more efficient capital structure under Solvency II.

### Standard Life Group

- 2.2 SL is the holding company for the SL Group and is listed on the London Stock Exchange. It was established in 2006 on the demutualisation of SLAC. The business of the SL Group is primarily related to the provision of long term insurance and investment related products for the retail or wholesale markets. As well as the principal subsidiaries of SLAL (long term insurance) and Standard Life Investments ("SLI") (investment management and products) in the UK, the SL Group has a multinational presence, with subsidiary or joint venture companies focussing on the domestic markets in Canada, China (and separately in Hong Kong), and India. SLAL maintains branches in Germany (which includes Austrian business) and in the Republic of Ireland ("ROI") to extend its European reach but there is also a separate company in the ROI, Standard Life International Limited ("SLIL"), which is a subsidiary of SLAL and which focuses on cross-border sales. Since 2006, the SL Group has disposed of some businesses, including those providing banking and healthcare insurance services, which it inherited from SLAC and has exited those sectors of the market but has acquired other companies which complement the delivery of its business strategy. Most of the businesses of the SL Group have no direct dealings with SLAL (or SLIF) and it is not necessary for the purpose of the Scheme Report to describe the activities of these companies further, even where these are direct subsidiaries of SLAL. A simplified structure chart of the SL Group is shown in Appendix 5.
- 2.3 The current business strategy is based on a three year transformation of the business focused on meeting the long term savings and investment needs of its customers. The business model aims to deliver shareholder value through: increasing assets under management; maximising revenues; reducing unit costs and increasing cash profitability. In doing so, it has taken significant steps to de-risk its activities and to operate on a "capital-lite" model, which it is believed will position it well under the proposed Solvency II regulatory regime (see Appendix 4).

### Governance

- 2.4 As a financial conglomerate operating in a number of jurisdictions, SL's operating policies and controls must have regard to the local requirements applicable to each company but must also set overarching principles and practices for the management of its business. These must be established at the SL Group level since the businesses must satisfy EU regulatory capital requirements, as well as satisfying accounting and listing disclosure rules, all of which require a clear risk management and control structure to be imposed. Additionally, SL must ensure that the procedures being adopted in its operating companies are in line with local conduct of business rules or SL's own requirements where these are more onerous.
- 2.5 The SL Board remains the ultimate governing body for the SL Group. As with most major companies it directs SL's affairs through a number of Board sub-committees which have oversight of specified aspects of its activities. There are delegated authorities to management and to the local operating entities.
- 2.6 SL maintains a central Group-wide management function to impose global control and direction on the business but allows local management a degree of autonomy in the operation of each business, although subject to the constraints of its governance arrangement as described in its Risk Policy Framework.

### Risk Policy Framework

- 2.7 The Risk Policy Framework consists of an overarching statement that sets out the approach which must be adopted in setting individual risk policies by allocating governance responsibility and

establishing requirements for the identification, management, mitigation and reporting of risks. The policy also requires there to be appropriate oversight and compliance sign off.

- 2.8 There are a number of principles established which provide an ethical background to the way that the businesses of the SL Group are to be managed.
- 2.9 Risk policies exist which address the following risks:
- Market Risk;
  - Credit Risk;
  - Liquidity and Capital Management;
  - Demographic and Expense Risk;
  - Operational and Strategic Risk;
  - Customer Proposition; and,
  - Group Related risks such as transfer pricing, transactions and strategic investments.
- 2.10 This framework guides the SL Group's Risk Appetite and Capital Management Policy.

### **Risk Appetite and Capital Management Policy**

- 2.11 The Risk Framework establishes the approach to managing risks but it is also necessary for measurable boundaries to be set on the amount of risk to which an undertaking is exposed having regard to its available capital and its relationship with its policyholders and its investors. This can be presented in a number of ways, such as by limiting the net contribution from any particular risk component, by setting boundaries on the change in earnings or by reference to the capital cover. Related to the latter point is the nature of the capital and its location.
- 2.12 SL employs a Capital Management Policy which aims to retain its capital at the highest possible level within the operating structure. This leads to preference for capital to be held by SL rather than by its subsidiaries and within shareholder funds of its subsidiaries rather than within the long term business funds of those subsidiaries. This approach allows the greatest flexibility in applying capital quickly and readily to wherever it is most usefully employed in the SL Group.
- 2.13 In applying this policy to SLAL and SLIF, SL aims to cover the regulatory capital requirements of the individual funds with assets held within those funds but to provide an appropriate level of cover from capital held in the associated shareholder funds. The policy does not prescribe how well covered the position should be at a subsidiary level.

### **Dividend policy**

- 2.14 The payment of dividends to the shareholders is a routine element of the management of the companies. SL operates a progressive dividend policy which also has regard to market conditions and the SL Group's overall financial performance. It is therefore dependent to some extent on the ability of its subsidiaries to pay dividends to it as well as their financial performance. In turn, the ability for subsidiaries to pay dividends could be significantly influenced by the Capital Management Policy.
- 2.15 The payment of a dividend must be approved by the Board of the company making the payment and the decision to do so must be taken having regard to the needs of the company rather than the requirements of the shareholders. There are legal requirements affecting the ability of a company to pay a dividend (e.g., that it should be paid from retained earnings). In the case of an insurance company, there is a further constraint that the capital remaining after the payment of the dividend must be sufficient to cover the capital requirements of the firm. As noted above, as a minimum, this will require that the statutory solvency position be covered but should have regard to the more stringent capital policy which the company operates.

## SLAL

### History

- 2.16 SLAL is the principal operating entity in the SL Group. SLAL was incorporated in 2006. It is a shareholder owned company authorised under the terms of FSMA to undertake long term insurance business in Classes I, III, IV, VI and VII<sup>1</sup>. SLAL received all of SLAC's European long term business under the terms of the 2006 Scheme. It has branch operations in Germany and the ROI. It also has a very small amount of liabilities in Canada as a result of the 2006 Scheme, although these are for all purposes part of the SL Group's Canadian operations.
- 2.17 SLAL is also the parent company of SLIF and of Standard Life Pensions Funds Limited ("SLPF"), a company limited by guarantee. SLAC is also a subsidiary of SLAL but its role is to hold residual items which were not able to be transferred under the 2006 Scheme. Since SLAC's assets and liabilities are effectively re-allocated to other entities within the Group under the 2006 Scheme, SLAC is not considered further in this report.

### Structure and operation

- 2.18 SLAL's structure and operational arrangements are driven by the requirements of the 2006 Scheme.
- 2.19 As with all shareholder owned life insurance companies in the UK, SLAL maintains two separate funds:
- a Shareholder Fund ("SHF"); and,
  - a long term business fund ("LTBF").
- 2.20 The LTBF represents the assets and liabilities of the insurance contracts insured by SLAL. The LTBF has five sub-funds:
- the Heritage With-Profits Fund ("HWPF");
  - the UK Smoothed Managed With-Profits Fund ("UKSWPF") ;
  - the German With-Profits Fund ("GWPF");
  - the German Smoothed Managed With-Profits Fund ("GSWPF"); and,
  - the Proprietary Business Fund ("PBF").
- 2.21 The HWPF was created under the terms of the 2006 Scheme and consists of all of the UK, Irish, and German (including Austrian) business of SLAC written prior to demutualisation, both with-profits and non-profit, with the exception of a small number of non-profit classes and Self Invested Pension Plans ("SIPP") which were transferred to the PBF. Increments to policies allocated to the HWPF are written in the HWPF, as is the investment element of a restricted amount of UK and Irish accumulating with-profits business transacted since demutualisation. The shareholders are entitled to the profits arising on the non-profit business and on some classes of accumulating with-profits business in the HWPF but the terms of the 2006 Scheme may restrict the withdrawal of these profits from the HWPF. The operation of this fund is described further in 2.43-2.50. The HWPF owns SLPF.
- 2.22 The UKSWPF consists of the investment element of UK with-profits Stakeholder pension business written in the PBF since demutualisation.
- 2.23 The GWPF consists of the investment element of all German (and Austrian) with-profits business other than smoothed managed with-profits business written in the PBF since demutualisation.
- 2.24 The GSWPF consists of the investment element of all German and Austrian smoothed managed with-profits business written in the PBF since demutualisation.

<sup>1</sup>Classification of long term insurance business: I - life and annuity, III - property-linked long term, IV - permanent health, VI - capital redemption contracts and VII - pension fund management.

- 2.25 The PBF consists of the small number of non-profit classes (see 2.21) transferred to it under the 2006 Scheme and all new business written by SLAL since demutualisation other than as allocated to the other funds as described in 2.21-2.24 above. Accumulating with-profits business is written in the PBF but the investment element is invested in the HWPF, the GWPF or the GSWPF (as appropriate), with the result that any profits arising from the charges levied on these classes of business arise in the PBF. A small amount of Canadian annuity business that was not transferred to the Standard Life Assurance Company of Canada ("SLACC") at demutualisation resides within the PBF. This business is fully reinsured to SLACC. There is also a small amount of German non-profit business within the PBF. All of the profits arising in the PBF are allocated to shareholders.
- 2.26 SLAL relies on outsourced service arrangements which are primarily provided by other SL entities. All management and administrative services required to manage the business at policy level are provided by a related company. These services are provided under the terms of a contractual arrangement but which results in SLAL reimbursing the other company at cost. Investment management is undertaken primarily by SLI but other third party managers are also used.

### Products and in-force detail

- 2.27 The following tables show the breakdown of SLAL's liabilities, annual premiums and number of policies across the major product groups and by sub-fund as at 31 December 2010. In these tables, "Other LTF" refers to the UKSWPF, the GWPF and the GSWPF and the figures are the aggregate for these funds.

£million	HWPF	PBF	Other LTF	Total
Non-linked	15,706	3,029	0	18,735
Accumulating with-profits	21,730	0	481	22,211
Property-linked	35,922	24,498	0	60,420
Index-linked	2,383	456	0	2,839
<b>Total Gross Liabilities</b>	<b>75,740</b>	<b>27,983</b>	<b>481</b>	<b>104,204</b>

Source: SLAL FSA Returns 31 December 2010

£million	HWPF	PBF	Other LTF	Total
Non-linked	272	8	0	279
Accumulating with-profits	965	0	176	1,142
Property-linked	878	1,436	0	2,314
Index-linked	0	3	0	3
<b>Total Annual Premiums</b>	<b>2,115</b>	<b>1,447</b>	<b>176</b>	<b>3,738</b>

Source: SLAL FSA Returns 31 December 2010

'000s	HWPF	PBF	Other LTF	Total
Non-linked	1,005	161	0	1,166
Accumulating with-profits	1,033	0	110	1,143
Property-linked	1,448	627	0	2,074
Index-linked	37	10	0	47
<b>Total Policies</b>	<b>3,521</b>	<b>798</b>	<b>110</b>	<b>4,429</b>

Source: SLAL FSA Returns 31 December 2010

- 2.28 There is a diverse range of contract types written in each of the funds but the generic description shown above will be sufficient for the purpose of this report. The non-linked contracts are written on fixed terms and largely consist of protection policies and annuities in payment. The property-linked and index-linked contracts are written on terms which permit some elements of the charges levied to cover the insured risks or to meet the expenses of administration to be varied in line with experience (or in line with a prescribed formula such as an inflation index). The discretionary powers are limited in respect of these contracts. Whilst accumulating with-profits contracts have many features similar to property-linked contracts in the way they operate, they are more dependent upon the experience of the fund in which they are invested as that is a determinant of the profits to be distributed and the benefits to be paid.

- 2.29 New business is largely non-profit or property-linked and is written in the PBF. New accumulating with-profits business is also written in the PBF but the with-profits element is invested in the HWPF. Accumulating with-profits business is also written in the UKSWPF (if it is UK Stakeholder pensions business) and the GWPF and the GSWPF (if it is German or Austrian business).
- 2.30 The following table shows the breakdown of SLAL's new business written during 2010, in terms of premiums and policyholders, across the major product groups.

	Regular Premium		Single Premium	
	Policies	Premiums £million	Policies	Premiums £million
Non-linked	421	1	23,969	377
Accumulating with-profits	13,891	33	558	151
Property-linked	97,574	554	31,692	6,100
Index-linked	0	0	221	11
<b>Total</b>	<b>111,886</b>	<b>588</b>	<b>56,440</b>	<b>6,639</b>

Source: SLAL FSA Returns 31 December 2010

### Reinsurance arrangements

- 2.31 SLAL is party to various intra-group reinsurance ("IGR") arrangements. A number of these were in place prior to demutualisation whilst others were implemented under the terms of the 2006 Scheme. Further arrangements were entered into after demutualisation reflecting the structure of SLAL's LTBF.
- 2.32 The objectives in implementing (or continuing) the reinsurance arrangements for SLAL as part of the 2006 Scheme were to reduce or remove the direct risks borne by the HWPF after demutualisation, to retain the management efficiencies derived from having internal funds managed in one location and to reflect the interests of shareholders in the financial structure which was created. (Internal funds related to the unit-linked endowment class were not reinsured to SLIF.) Since demutualisation, further reinsurance treaties have been added which have built on the structure.
- 2.33 The majority of these arrangements involve business being reinsured from SLAL to SLIF although there is one treaty which passes risk back to SLAL. These are summarised below.

Agreement	Parties	Scope
SLIF EB Annuities	HWPF to SLIF	Longevity risk from all non-profit annuities in payment in the HWPF prior to demutualisation and original terms reinsurance of any augmentations to them (to the extent not reinsured to a third party).
SLIF EB ULL	HWPF to SLIF	Investment element of all UK and Irish property-linked life business in the HWPF written prior to demutualisation.
SLIF EB ULP	HWPF to SLIF	Investment element of all UK and Irish property-linked pension business in the HWPF written prior to demutualisation.
SLIF NB	PBF to SLIF	Original terms reinsurance of all new business written in the PBF apart from accumulating with-profits business, smoothed managed with-profits business and non-profit protection and SIPP business. New annuities written in the PBF but arising from maturing contracts in the HWPF are also within the scope of this treaty.
UK SIPPs	PBF to SLIF	Investment element of all SIPPs written prior to 10/07/2006 and transferred to the PBF at demutualisation.
New SIPP Business	PBF to SLIF	Original terms reinsurance of the investment element of SIPP business written in the PBF after 10/07/2006.
SLIF Stop-Loss Retrocession	SLIF to PBF	"Tail risk" related to the longevity risk on business covered by the SLIF EB Annuities treaty.

- 2.34 The original scope of the SLIF EB Annuities Agreement included all of the annuities in the HWPF but a significant proportion of the annuity business covered by it was recaptured by the HWPF in 2008 and reinsured externally to Canada Life. The arrangement with Canada Life removed credit and market risk related to the assets backing the reinsured annuity business in addition to the longevity risk. There are appropriate security arrangements in place in relation to this treaty to mitigate the counterparty risk which would exist otherwise in respect of the premium paid to Canada Life.
- 2.35 SLAL also reinsures risks arising from its non-linked protection business to external reinsurers and from its group risk protection business to SLPF.
- 2.36 The effects of these treaties on SLAL which are relevant to the considerations of the Scheme Report are:
- the HWPF has no material exposure to the longevity risks related to the annuity business allocated to it but retains the credit risks related to the assets backing this business (in respect of the portion of this business not reinsured to Canada Life);
  - SLIF bears the longevity risk on the annuity business retained by the HWPF up to the pre-set limit under the stop-loss treaty;
  - the PBF bears the risk under the stop-loss treaty of longevity being significantly better than assumed in respect of the annuity business reinsured from the HWPF to SLIF;
  - materially all of the investment funds related to the property-linked business in the HWPF and the PBF are located in SLIF; and,

- much of the new business written in the PBF is reinsured to SLIF on original terms so that SLAL does not meet directly the costs and strains related to this new business.

2.37 The resulting net insurance liabilities of SLAL as at 31 December 2010 after allowing for these reinsurance arrangements are shown below:

Liabilities	£million	HWPF	PBF	Other LTF	Total
Non-linked		10,058	22	0	10,080
Accumulating with-profits		21,730	0	481	22,211
Property-linked		45	58	0	103
Index-linked		1,279	0	0	1,279
<b>Total Net Liabilities</b>		<b>33,112</b>	<b>80</b>	<b>481</b>	<b>33,673</b>

Source: SLAL FSA Returns 31 December 2010

### Approach to financial management & policyholders' reasonable expectations

2.38 Under the FSA regime, a concept of treating customers fairly ("TCF") should be applied. This requires actions to be considered not only by reference to the way such actions may have applied in the past but also in an absolute sense. The concept of TCF goes much further than simply recognising policyholders' reasonable expectations ("PRE"). The key features which I believe should be considered in addressing TCF and PRE are:

- security of benefits: this is the expectation that benefits will be paid as they fall due; and,
- fair treatment: this must be assessed in the context of the effects which actions may have on different classes or generations of policyholders or on shareholders but should have regard to, amongst other things, contractual terms and the way in which the contracts have been promoted and managed in the past ("implied terms") but also whether actions are reasonable and balanced having regard to policyholder interests.

2.39 To some extent, PRE will have been formulated by the communications given to customers both at the point of sale and subsequently, or by other statements of practice. For with-profits business a typical statement of practices has been contained in the With-Profits Guide which was published from 1988 until 2005. This described the general approach to financial management and the setting of bonuses, as well as giving some historical financial information on asset allocation and expenses. A much fuller and more detailed description of the financial management of with-profits business is now set out in the PPFM which with-profits companies must maintain and make available to policyholders. I have taken the PPFM as the starting point in my assessment of PRE for with-profits policyholders.

2.40 In the following sections reference is made to asset shares and it will be useful to describe what these are and the role they play in the management of with-profits business.

2.41 Generally speaking, the asset share of a policy is an accumulation of the premiums paid, allowing for the investment returns earned, after tax if appropriate, but also after deducting the costs of administering the contract, commission payments, charges for insurance risks and guarantees, and deduction for shareholders' share of profits, where appropriate. The asset share therefore represents broadly the accumulated value related to each policy based on the fund's performance and experience during the policy's period in force. Asset shares can be calculated for each individual policy or may be calculated by reference to modelled or specimen policies and a model created to represent the whole of the in-force business.

2.42 The asset share does not provide the policyholder with any additional rights either to the assets underlying the asset share or, indeed, to any value equivalent to the asset share value as the company retains full discretion up to the point of claim to pay a value different from the asset share. In practice, subject to smoothing, the asset share serves as a reference point from which fair payouts could be measured and is a major determinant of PRE and TCF for with-profits contracts.

### Core Principles and the PPFM

2.43 The 2006 Scheme established a set of Core Principles to be followed in the management of the HWPF. Additionally, SL's governing principles place a high weighting on the treatment of policyholders.

- 2.44 The Core Principles for the HWPF, which are set out in the 2006 Scheme, set out a framework which was aimed at providing continuity with the regime which had applied in SLAC prior to demutualisation. The key elements of the Core Principles are:
- Investment Policy and Bonus Policy, and the definition of a “Notional Company” and its capital structure which should be used to establish the investment policy for the HWPF;
  - the use of asset shares to ensure equity between groups of with-profits policyholders; and,
  - the role of the residual estate, to ensure that a prudent amount is retained to cover amounts which may be charged to the HWPF, but if it is established that the amount of the residual estate is greater than the amount prudently required, it shall be distributed in a fair and equitable manner to with-profits policies transferred from SLAC.
- 2.45 The PPFM sets out in more detail how these Core Principles are applied. For the purpose of this report, I consider that setting out the Core Principles will be sufficient since these describe the elements of the management of the HWPF which could be susceptible to change under the Scheme (and in particular the application of the Notional Company). Consequently, I do not believe that it is necessary to describe further the PPFM for the HWPF.
- 2.46 SLAL maintains separate PPFM documents for the HWPF and the UKSWPF. These documents are only required for the UK business and do not relate directly to the Irish or German (including Austrian) with-profits business. However, the principles and practices used in the other jurisdictions are very similar. Having considered the content of these documents and the operation of the UKSWPF the GWPF and the GSWPF, it is clear that these funds are not directly affected by the current reinsurance arrangements since none of this business is ceded to, or received from, SLIF. They are also ordinarily reliant on their own resources in determining policyholder benefits but ultimately rely on the security of SLAL for those benefits. I have therefore not set out the detail of the PPFMs or operating practices for them but consider them generally within the context of the policyholders of SLAL.

#### Other requirements of the 2006 Scheme

- 2.47 The 2006 Scheme created a structure which allowed the shareholder to participate in the profits of the HWPF arising from certain defined blocks of business. The structure also imposed constraints which prevented the profits being transferred to the shareholder unless a number of tests were satisfied. These tests were required to ensure that sufficient surplus remained in the HWPF on both a regulatory and on a realistic basis, so that profits arising on the defined blocks of business could not be transferred at times when the with-profits business was under any stress.
- 2.48 Amounts which cannot be transferred are accumulated in the HWPF where they provide a support mechanism until they may be released for the benefit of the shareholder (i.e., to the SHF or the PBF).
- 2.49 The amount to transfer is based on the calculation of Recourse Cash Flows (“RCF”), which is effectively the non-investment surplus arising on the defined block of business in the HWPF. The formulae used to calculate the RCFs are described in the 2006 Scheme. The formulae make allowance for the effects of external reinsurance arrangements.
- 2.50 The 2006 Scheme provides for various other Capital Support Mechanisms for the HWPF, which are summarised below:
- if the calculated transfer amount is negative, SLAL must provide for a contingent loan to be advanced to the HWPF, or make assets available in some other way, so that this amount is offset;
  - in addition to this, SLAL can arrange for a contingent loan or assets to be made available to the HWPF from any other SLAL funds as it sees fit, on terms set by the SLAL Board; and,
  - the 2006 Scheme specifically contemplates that the HWPF may enter into an arrangement to securitise some or all of the value of its future RCFs. Such an agreement was indeed entered into post-demutualisation and is described in 2.62.

## Governance and discretionary powers

- 2.51 Many of the products (primarily property-linked contracts) underwritten by SLAL are subject to charges which may be reviewed at the discretion of SLAL. The reviewable charges include the deductions made for risk benefits, policy fees, bid/offer spread and annual management charges. SLAL has well documented procedures on the review of these charges and their application. All policies are processed in a manner consistent with policy conditions and policyholder communications. Reviews and supporting analysis and calculations are consistently applied from year to year.
- 2.52 SLAL maintains a With-Profits Committee ("WPC") to provide an independent assessment of SLAL's compliance with its PPFM and to review any discretionary powers exercised by the Board. The WPC satisfies the requirements of COBS 20 in this regard.

## Financial condition

- 2.53 A summary of the regulatory requirements on determining the financial position of a firm transacting long term business is shown in Appendix 3. The summary shown there applies equally to SLAL and SLIF, as insurance companies. The published regulatory returns for a long term insurer demonstrate the financial position on a basis consistent with the EU Directive requirements (referred to as Pillar 1, Peak 1).
- 2.54 Insurance companies must hold additional capital at least sufficient to cover the capital resources requirement ("CRR"). The CRR has several components which are formulaically established and these are included in the Long Term Insurance Capital Requirement ("LTICR"). Companies must also hold capital to cover a robustness test of the resilience of the valuation assumptions, the Resilience Capital Requirement ("RCR"). However, larger with-profits firms (such as SLAL), do not have to undertake this test but are subject to an adjustment in respect of their with-profits business to avoid overstating the available capital (referred to as the With-Profits Insurance Capital Component or "WPICC"). This adjustment is determined on a realistic basis (referred to as Pillar 1, Peak 2).
- 2.55 In addition, a firm must maintain a capital requirement based on its individual capital assessment of the risk ("ICA capital") plus any additional requirement imposed by FSA under individual capital guidance ("ICG"). Pillar 2 figures reflect the capital needed by an insurance company to withstand a 1 in 200 stress event on a realistic basis.
- 2.56 The regulatory Peak 1 presentation reflects all of the liabilities of SLAL, as compared to the Peak 2 realistic balance sheet which focuses on with-profits business. The realistic balance sheet presents a fuller picture of the liabilities which SLAL has to its with-profits policyholders having regard to both contractual guarantees and benefit expectations. In combination, the twin peaks ensure that the mathematical reserves held are adequate and that additional capital of a prescribed quality is maintained.
- 2.57 A summary of SLAL's Pillar 1 position as at 31 December 2010 is shown in the following table. SLAL's Peak 2 position at this date is shown in Appendix 2.

£million	HWPF	PBF	Other LTF	Total
<b>Admissible Assets</b>	<b>44,121</b>	<b>445</b>	<b>519</b>	<b>45,085</b>
Net Liabilities	33,133	81	481	33,695
Other Liabilities	6,998	308	5	7,311
<b>Total Liabilities</b>	<b>40,131</b>	<b>389</b>	<b>486</b>	<b>41,006</b>
Excess Assets	3,990	56	33	4,079
SHF	-	-	-	2,646
<b>Total Capital Resources (A)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>6,725</b>
LTICR	-	-	-	1,602
RCR	-	-	-	N/A
WPICC	-	-	-	1,122
BCRR	-	-	-	N/A
<b>Solo Capital Resources Requirement</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,724</b>
ICRR - other subsidiaries	-	-	-	188
<b>Capital Resources Requirement (B)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,912</b>
<b>CRR Cover (A/B)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>231%</b>
Dividend	-	-	-	300
<b>CRR Cover, post dividend</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>221%</b>

Source: SLAL FSA Returns 31 December 2010

- 2.58 From this table it can be seen that SLAL covered its regulatory capital requirement by 221% after allowing for planned dividends at 31 December 2010. It should be noted that this statistic is influenced by the fact that SLIF is in effect included in these figures as SLIF (and indeed SLPF) are subsidiary companies of SLAL. In particular, in the above table, the net available assets of SLIF are included in the entry for SHF and its CRR is included in ICRR – Other Subsidiaries. SLAL’s other subsidiary insurance companies, SLPF and SLIL, are also included in these lines.
- 2.59 Since SLAL also reports on a realistic Peak 2 basis, part of its capital requirement relates to its WPICC. Although this is shown as a capital requirement it remains part of the risk absorbing capital of the with-profits business. It tends to reduce artificially the apparent level of cover for the capital resources requirement.
- 2.60 The largest part of the LTICR directly required in SLAL relates to the HWPF since the retained liability in the PBF after the effects of the reinsurance arrangements is minor. Since SLIF and SLPF are insurance subsidiaries of SLAL, they each have to maintain a CRR in respect of their business and the net capital resources and capital requirement must be consolidated in SLAL’s financial position. Consequently, the presentation above does also include the CRR in respect of the reinsured business and of SLPF.

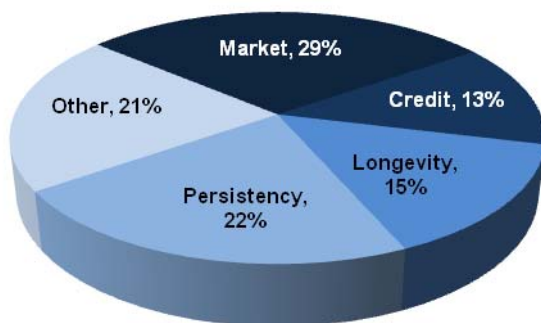
### Contingent loans

- 2.61 A contingent loan facility (the “Dublin Loan”) exists between SLAL and SLIF under which SLIF can draw funds from SLAL and make repayments out of its statutory surpluses. The outstanding value of this loan at 31 December 2010 was £88.9 million. This arrangement is described in more detail in 2.97.
- 2.62 The 2006 Scheme anticipated the possibility of financing arrangements being created in respect of the future RCF from the HWPF. On 31 December 2009, a series of agreements were entered into with the net effect of the SLAL SHF advancing a contingent loan of £588 million to the HWPF (the “Etive loan”), securitising part of the future RCFs in the HWPF. The outstanding value of this loan as at 31 December 2010 was £314 million. The effect of this arrangement was to ensure that amounts (up to the value of the Etive loan) which would be extracted from the HWPF in the future would be made on

the expected tax-free basis but also that the financial position of the HWPF was maintained by means of the contingent loan.

**Risk profile**

- 2.63 I have considered SLAL's own risk based assessment of its capital needs in its ICA. Although the quantitative results may not be presented in this report since the ICA results are a private submission to the FSA, I have considered the contribution which the main classes of risk make to the capital requirement in the ICA. I consider this as a measure of the relative risks which exist in SLAL currently and to which SLAL's policyholders are ultimately exposed either in respect of their security or benefit expectations. Since SLAL and SLIF are very much entwined operationally and financially, the ICA considers both companies as a single entity although separate analyses are also undertaken.
- 2.64 The largest individual risk to which SLAL is exposed is market risk. The main component of this risk is exposure to falls in the equity market, which would result in a contraction of unit funds and a reduction in charges generated from property-linked products.
- 2.65 Persistency risk is the second largest risk to which SLAL is exposed. This is the risk that higher than anticipated lapse rates result in a fall in charges generated from property-linked products, or in a reduction in shareholder-allocated surplus from the with-profits book. SLAL also has a material exposure to longevity risk and credit risk.
- 2.66 The following graph shows the breakdown of SLAL's Pillar 2 capital requirement as at 31 December 2010, before diversification benefits.



Source: December 2010 ICA results Board paper

- 2.67 It is also noted that since SLAL is the parent of SLPF and SLIL, the ICA analysis also has regard to the risks to which they are exposed. SLAL could be called upon to provide capital to these companies, either in support of their new business activities or for other reasons. As they are separately established limited companies, SLAL would not be required to provide such support (although it may do so for other reasons such as to protect its reputation).

**Risks transferred under agreements**

- 2.68 I noted in 2.36 what the effects of the intra-group reinsurance arrangements were in altering the net exposures of each of the funds to which they applied. In the following section I consider further the effects of these arrangements.
- 2.69 One consequence of entering into the reinsurance arrangements is that the reinsured fund (and consequently SLAL) accepts a degree of counterparty risk that SLIF may default on its liabilities. Given the nature of SLIF's business (which is described later from 2.72 onwards), it is unlikely that an intra-group arrangement such as this would produce material counterparty risks. Additionally, SLAL is a beneficiary under the floating charges on the assets of SLIF to the value of the reinsured liability should an administrator or liquidator be appointed to SLIF. There are separate charges in respect of the property-linked liabilities and the non-linked liabilities (which primarily relate to the annuity business not reinsured externally). This also gives protection against the lower ranking which would

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otherwise be placed on reinsurance liabilities relative to direct policy liabilities in the event of insolvency (although SLIF has not traded directly and has only ever acted as a reinsurer). The protection afforded by the floating charge does not extend to providing direct policyholder protection to SLAL's policyholders in the event that SLAL defaulted as in those circumstances the reclaimed assets may simply be allocated to the general pool of available assets rather than being directly attributable to the benefits of policyholders whose policies were subject to the reinsurance. In other words, SLAL benefits from the floating charge rather than its policyholders directly.

- 2.70 The longevity risk related to the annuity business of the HWPF that is not reinsured externally is reinsured to SLIF. However, the risks then reside in SLIF which is a subsidiary of SLAL's SHF. Further, the stop loss treaty which exists between SLIF and the PBF in respect of the longevity risk in the annuity business may protect SLIF from extreme improvements in longevity but the risk is then placed firmly in the PBF. Consequently, although the effect is to remove the direct liability from the HWPF, the financial position of SLAL is influenced by the experience of the annuity reinsurance in SLIF. In other words, the security of the HWPF still has a minor exposure arising from longevity risk in the annuity business.
- 2.71 SLAL reinsures much of its new business to SLIF on an original terms basis which has the same effect as if SLIF had written the business directly since it reimburses SLAL for the expenses incurred in transacting the business. Whilst the arrangement means that the expenses and strains of writing new business occur in SLIF rather than in SLAL, SLAL must ensure that its subsidiary has sufficient capital to fund the initial expenses of transacting new business and to meet its prudential requirements in reserving and capital resources. In practice, the arrangement does not materially change the financial management of the affected business but it may be advantageous in permitting SL to identify shareholder profits arising in SLAL and to ensure their availability to pay dividends.

## SLIF

### History

- 2.72 SLIF is a shareholder owned company authorised under the terms of FSMA to undertake long term insurance business in Classes I, II, III, IV, VI and VII<sup>2</sup>. SLIF has not transacted business in Class II.
- 2.73 SLIF is a wholly owned subsidiary of SLAL's SHF.

### Structure and operation

- 2.74 As with all shareholder owned life insurance companies in the UK, SLIF maintains two separate funds: a SHF and a LTBF.
- 2.75 SLIF has never transacted direct insurance business but has always acted as a reinsurance company, primarily in respect of business reinsured from SLAL or SLPF. It also accepts reinsurance from other third party insurance companies owned by external fund managers. ("EFM" is used in this report to denote such insurance companies). The reinsurance arrangements are noted in 2.80, below.
- 2.76 The nature of the reinsurance received by SLIF is mainly property-linked business apart from annuities written in the PBF since demutualisation and the longevity risk related to the residual block of annuities that it reinsures from the HWPF. The nature of the reinsurance business that it accepts from SLPF or from the EFMs is largely property-linked pension business, both individual and group.
- 2.77 The distribution of SLIF's in-force business by source as at 31 December 2010 is shown in the following table:

£million		Non-linked	Property-linked	Index-linked	Total
<b>Reinsurance Accepted</b>					
	HWPF	36	35,857	67	35,960
	PBF	2,172	24,427	216	26,814
	SLPF	0	1,068	0	1,068
	EFM	0	314	0	314
	<b>Total</b>	<b>2,208</b>	<b>61,666</b>	<b>282</b>	<b>64,156</b>
<b>Reinsurance Ceded</b>					
	External	0	(3,146)	0	(3,146)
	<b>Total</b>	<b>0</b>	<b>(3,146)</b>	<b>0</b>	<b>(3,146)</b>
<b>Net Liabilities</b>		<b>2,208</b>	<b>58,520</b>	<b>282</b>	<b>61,010</b>
<b>Other Liabilities</b>					<b>160</b>
<b>Total Net Liabilities</b>					<b>61,170</b>

Sources: SLIF FSA Returns 31 December 2010 & information provided by SL for the purpose of this Report

- 2.78 All of the profits from SLIF's business accrue to its shareholder, the SLAL SHF.
- 2.79 Operationally, SLIF relies on other SL Group companies for most of its management and administrative services. It is allocated a share of the costs incurred in respect of these services. Some investment services are provided by third party investment managers in respect of the outward reinsured business.

### Reinsurance arrangements

- 2.80 The IGRs by which SLIF has ceded or written reinsurance are summarised below:

<sup>2</sup> Classification of long term insurance business: I - life and annuity, II - marriage and birth, III - linked long term, IV - permanent health, VI - capital redemption contracts and VII - pension fund management.

Agreement	Parties	Scope
SLIF EB Annuities	HWPf to SLIF	Longevity risk from all non-profit annuities in payment in the HWPf prior to demutualisation and original terms reinsurance of any augmentations to them (to the extent not reinsured to a third party).
SLIF EB ULL	HWPf to SLIF	Investment element of all UK and Irish property-linked life business in the HWPf written prior to demutualisation.
SLIF EB ULP	HWPf to SLIF	Investment element of all UK and Irish property-linked pension business in the HWPf written prior to demutualisation.
SLIF NB	PBF to SLIF	Original terms reinsurance of all new business written in the PBF apart from accumulating with-profits business, smoothed managed with-profits business and non-profit protection and SIPP business. New annuities written in the PBF but arising from maturing contracts in the HWPf are also within the scope of this treaty.
UK SIPPs	PBF to SLIF	Investment element of all SIPPs written prior to 10/07/2006 and transferred to the PBF at demutualisation.
New SIPP Business	PBF to SLIF	Original terms reinsurance of the investment element of SIPP business written in the PBF after 10/07/2006.
SLIF Stop-Loss Retrocession	SLIF to PBF	"Tail risk" related to the longevity risk on business covered by the SLIF EB Annuities treaty.
TIP Agreement	SLPF to SLIF	All liabilities falling under three Trustee Investment Plans ("TIP"s) written by SLPF.

- 2.81 The treaties listed above are those listed for SLAL in 2.33, plus an original terms treaty between SLPF and SLIF in respect of property-linked approved pension arrangements.
- 2.82 In addition, SLIF has entered into various agreements with EFMs under which it has accepted or ceded reinsurance on property-linked pensions business. These relate to the investment elements of the reinsured contracts only.
- 2.83 SLIF has reinsured all or part of its liabilities under some UK property-linked contracts to external companies. SLIF receives protection under these contracts in the form of floating charges on the assets of the direct writers in the same way that it offers such assurances to its policyholders. (There is one reinsurance arrangement ceded which is protected by a security trust agreement. However, I understand that in all material respects the protection afforded is identical to that under a floating charges arrangement.) The format of the floating charges and the security trust follow industry standard wording, and ensure that SLIF ranks alongside the direct insurance customers of the reinsurers.
- 2.84 The TIP Agreement reinsures three TIPs written by SLPF. When this reinsurance treaty was initially arranged, the ceding company required that the benefits reinsured should be insulated from other risks within SLIF, in particular the risks arising from the annuity business reinsured into SLIF from SLAL.

- 2.85 This requirement was satisfied by the introduction of floating charges on the assets of SLIF. SLAL and SLPF became beneficiaries under these charges as did other EFMs when they ceded risks to SLIF thereafter. There are separate charge arrangements in respect of the non-profit (mainly annuity) business from SLAL and SLPF (although there is no business of this type currently reinsured from SLPF under this treaty) and the property-linked business from SLAL, SLPF and the EFMs. The assets identified for the purpose of each charge are the assets which back that class of business.
- 2.86 The charges in respect of the property-linked business from SLAL, SLPF and the EFMs are such that all of the assets in the property-linked funds maintained by SLIF from time to time would be available for the beneficiary companies if SLIF became insolvent. The effect of the charge would be to allow the reinsured party to recover an amount up to the value of its reinsured liability (after allowing for any expenses of the security trustee), based on the pro-rated value of the internal property-linked funds in SLIF.
- 2.87 The property-linked treaty and charge do not grant any guaranteed value to the reinsured so SLIF does not bear any additional investment risk. It is therefore possible for the property-linked liabilities of the reinsured parties to exceed the value of the assets available under the charge. It is also possible that the assets recovered if the charge applied may not be the assets in which the reinsured funds had been invested since the protection is intended to secure only an appropriate share of the value of the reinsured funds.
- 2.88 The charge in respect of the non-profit business applies to all of the remaining assets of SLIF's LTBF not captured by the property-linked business charge. The aim of this charge is to secure that SLAL is adequately protected against any other claims which may arise in relation to the insolvency of SLIF and which would leave it potentially ranking behind the other creditors. SLPF would benefit from this arrangement to the extent that any annuity benefits arising from its investment contracts were subject to the reinsurance from SLPF to SLIF but in practice such benefits have been purchased directly from SLAL and would be covered by SLAL's interests. Therefore, SLPF would not currently benefit from this charge in practice.
- 2.89 The SLIF EB Annuities agreement has been supplemented with a Memorandum of Understanding between SLAL and SLIF which is intended to align the treatment of the reinsured and direct annuity payments when inflationary increases on these are contractually capped.

#### Financial effect of reinsurance and sources of profit

- 2.90 In this section I consider the financial aspects of the reinsurance treaties in SLIF.
- 2.91 The SLIF EB ULL and the SLIF EB ULP treaties are such that the HWPF bears all of the expense risks of the business covered by these treaties. SLAL deducts the policy level charges from the premiums received and remits the investible portion to SLIF. SLIF remits to SLAL the charges deducted from its internal funds in respect of the reinsured business. In practice the profits from this business emerge in SLAL's HWPF. So that the SLIF EB ULL treaty ranks as insurance business, the benefits payable to the HWPF on the death of a policyholder are 100.1 % of the available unit value. SLIF does not charge for this slight uplift to the benefit but must provide for it in its mathematical reserves. The value held was trivial at £1.6 million as at 31 December 2010.
- 2.92 The SLIF EB Annuities treaty covers the HWPF's liability for longevity risk in respect of the annuities in payment at demutualisation, including any increments to those contracts since that time, to the extent that they are not reinsured to third parties. SLAL bears all administration, management, commission and brokerage costs and deals with policyholder administration related to the payment of benefits to policyholders, but it is reimbursed by SLIF for the initial expenses incurred for annuity increments. Investment management costs are borne by both companies in respect of the assets they hold. SLIF bears the longevity risk that the amount paid in respect of annuities in the HWPF will be greater than expected (but is not at risk in respect of the uncertain effects of inflation related payments), and profits or losses accrue to it. SLIF's exposure is limited by the existence of the SLIF Stop-Loss Retrocession treaty which transfers the risk of annuitants living much longer than expected from SLIF to the PBF. (In practice, the SLIF Stop-Loss Agreement does not remove the economic risk from SLAL's SHF but transfers the effects of longevity from being via its share-holding in SLIF to being via the PBF, from which all profits or losses flow to the SHF).

- 2.93 The SLIF NB Agreement is an original terms treaty and therefore SLIF effectively underwrites all of the new business arising in SLAL in the UK and the ROI (other than protection business and any accumulating with-profits business). SLIF procures the provision of all administration, customer service and management (including investment management) functions, including new business development costs but SLAL agrees to pay these costs if SLIF would otherwise be required to hold additional prudential reserves to cover all the expenses of running off the reinsured policies. SLAL is responsible for dealing with all policyholder contact but is reimbursed by SLIF for the costs of doing so. The profits arising on this business effectively arise in SLIF.
- 2.94 The UK SIPP Treaty is such that only the investment element is reinsured. The treaty is largely aimed at achieving efficiency in the investment management of the reinsured business and, as a result, is of little financial consequence for SLIF. The New SIPP Business Treaty is on an original terms basis and so SLIF is exposed to the expense risks but otherwise it has a similar effect.
- 2.95 The TIP Agreement is an original terms agreement covering the property-linked liabilities of TIPs within SLPF. SLIF bears the costs of all administration, customer service and management (including investment management) services as well as reimbursing SLPF for initial expenses incurred in writing the policies. However, should the level of charges or initial expenses increase, SLIF and SLPF will negotiate in order to determine which company should bear the costs of such an increase. The negotiation will have regard to, amongst other things, the terms of the investment management agreement, the reason for the charge increases and the ability of SLIF to recover the increased amount through increased policy charges.
- 2.96 The external reinsurance arrangements cover the reinsurance of the investment element of the original contracts, which are related to the provision of approved pension schemes. SLIF receives fees based on the amounts of funds under management and although it is not directly affected by market risks in respect of the liability, the recoverability of fees and therefore, the contribution to provide for SLIF's expenses and profitability, is subject to market risk.

#### Contingent loan (Dublin Loan)

- 2.97 SLIF incurs all of the costs related to the reinsured new business including the significant initial costs related to the sale of the business. Although these costs are expected to be recovered over time from the charges set out in the contracts, SLIF's capital position must bear this funding strain. Additionally, SLIF must have sufficient capital to meet the prudent reserves it must establish to cover the reinsured liability and the related regulatory capital requirement. This is monitored through SL's capital management processes but SLIF requires capital to be made available to it from time to time to ensure it remains sufficiently capitalised.
- 2.98 Additional capital may be provided in a variety of ways such as by injecting share capital or by providing contingent loans. Since SLIF is a wholly owned subsidiary of SLAL, SLAL is the primary source for the provision of additional capital. To this end, a contingent loan facility was set up in December 2007 between SLAL and SLIF which provides for a maximum of £300 million to be drawn down by SLIF (as the Dublin Loan described in 2.61). £150 million was drawn down from SLAL's SHF to SLIF's LTBF.
- 2.99 Repayment of the loan is contingent upon sufficient statutory surplus arising in SLIF. It is the contingent nature that allows SLIF not to show the outstanding amount of the loan as a liability in its statutory return and so to count it as available capital. Interest is payable by SLIF on the outstanding loan amounts (subject to the same contingency as just described for capital repayment) at a rate equal to LIBOR plus an "acceptable" margin.
- 2.100 The outstanding loan amount as at 31 December 2010 was £88.9 million. It is expected that this loan will be repaid prior to the implementation of the current proposed Scheme. Share capital will be injected into SLIF to the value of the repayment amount so that the overall amount of capital available in SLIF will not change.

#### Financial condition

- 2.101 SLIF must also maintain sufficient capital to satisfy its Pillar 1 and also its risk based ICA capital requirement. Since SLIF does not reinsure any with-profits business, it is not subject to the realistic basis reporting requirements of the Pillar 1 Peak 2 regime to which SLAL is subject. Consequently,

SLIF does not maintain a WPICC element in its capital requirements but must consider the need for an RCR, which is a test of the robustness of the valuation basis and the relationship between the nature and term of the assets and liabilities.

2.102 The financial position of SLIF as at 31 December 2010 is shown in the following table:

£million	Total
<b>Admissible Assets</b>	<b>61,435</b>
Gross Liabilities	64,156
Reinsurance	(3,146)
Net Liabilities	61,010
Other Liabilities	160
<b>Total Liabilities</b>	<b>61,170</b>
Excess Assets	265
SHF	68
<b>Total Capital Resources (A)</b>	<b>333</b>
LTICR	135
RCR	20
WPICC	N/A
BCRR	N/A
<b>Capital Resources Requirement</b>	<b>155</b>
ICRR - other subsidiaries	N/A
<b>Capital Resources Requirement (B)</b>	<b>155</b>
<b>CRR Cover (A/B)</b>	<b>215%</b>
Dividend	0
<b>CRR Cover, post dividend</b>	<b>215%</b>

Source: SLIF FSA Returns 31 December 2010

2.103 From this table it can be seen that SLIF met its regulatory capital requirements comfortably in covering its CRR by 215%. The nature of the liabilities in SLIF (being largely property-linked where the policyholders bear the investment risk and without investment guarantees) means that SLIF's CRR is low relative to the amount of its liabilities (e.g., by comparison with SLAL). SLIF has an RCR which reflects the sensitivities of the Pillar 1 methods used to establish prudential reserves for non-profit and property-linked business.

## Risk profile

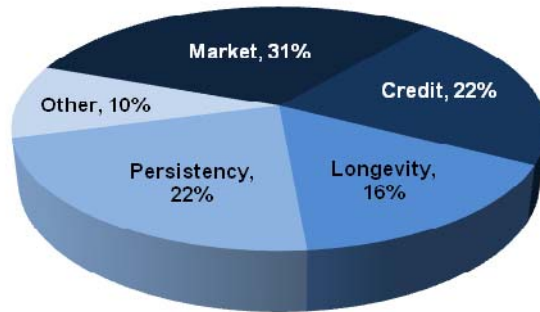
2.104 The SLAL ICA capital requirement looks through to SLIF's standalone ICA. However, SLIF must ensure that it covers its standalone ICA capital requirement.

2.105 SLIF has large exposures to market and lapse risks. These arise primarily from the fact that SLIF must recover sufficient charges from its in force business to cover the expenses it incurs, mainly in respect of the new business it has received from SLAL since 2006. The volume of business in force and the value of the internal funds to which this is linked are significant influences on the amount of charges which may be deducted. SLIF is not exposed to market risks related to investment guarantees. As noted in 2.92, SLIF is subject to longevity risk but this is capped by the stop loss treaty with SLAL. SLIF is also exposed to credit risk related to the annuity business reinsured on original terms from SLAL.

2.106 Additionally, SLIF is exposed to credit risk via counterparty risk from the business which has been reinsured with third party reinsurers. This is limited by the existence of floating charges in SLIF's favour and the ability to offset balances due.

2.107 SLIF is also exposed to operational risk in respect of the business it reinsures from SLAL. I understand that approval has been given by SLAL's Board for an indemnity to be given to SLIF in respect of the costs of such risk events occurring and exceeding £1 million per event. The indemnity has not yet been implemented but is expected to be put in place during 2011.

2.108 The following graph shows the breakdown of SLIF's Pillar 2 capital requirement as at 31 December 2010, before diversification benefits.



Source: December 2010 ICA results Board paper

### 3. OUTLINE OF THE SCHEME

#### Detailed description of the Scheme

- 3.1 Save in respect of terms defined elsewhere in this report, the terms used in this section follow the definitions set out in the Scheme.

#### Effective Date

- 3.2 The Effective Date is the date upon which the Scheme will be implemented and is expected to be 31 December 2011.

#### Transferred Assets, Transferred Liabilities and Transferred Policies

- 3.3 All of the assets and liabilities of SLIF will be transferred to SLAL ("Transferred Assets" and "Transferred Liabilities") on the Effective Date, except for any Residual Assets or Residual Liabilities (as defined in 3.8 and 3.9 below).
- 3.4 The Transferred Assets and Transferred Liabilities derived from SLIF's LTBF will be applied to SLAL's LTBF and will be allocated to the HWPF if they relate to the business reinsured to SLIF by the SLIF EB ULL Agreement or the SLIF EB ULP Agreement, and to the PBF otherwise. The Transferred Assets allocated to the HWPF will include an amount equal to the statutory mathematical reserve held by SLIF as at the Effective Date in respect of the sum at risk on death of 0.1% of the unit liability payable to the HWPF under the terms of the SLIF EB ULL Agreement. Tax Assets and Tax Liabilities derived from SLIF's LTBF will be allocated to the PBF, from which they will be apportioned to the PBF and the HWPF in accordance with the 2006 Scheme.
- 3.5 All of the Transferred Assets and Transferred Liabilities derived from SLIF's SHF will be transferred to SLAL's SHF. Tax Assets and Tax Liabilities derived from SLIF's SHF will be allocated to SLAL's SHF.
- 3.6 The reinsurance contracts which SLIF has accepted from SLPF and the EFMs ("Transferred Reinsurance Agreements") will be transferred to SLAL and will be allocated to the PBF. All reinsurance arrangements between SLIF and SLAL (both accepted and ceded) will cease to have effect on the Effective Date by operation of law.
- 3.7 The non-linked floating charge agreement granted by SLIF to SLAL will be cancelled on the Effective Date. The property-linked floating charge agreement will be amended to provide a charge on SLAL's property-linked assets instead of on SLIF's property-linked assets.

#### Residual Assets and Residual Liabilities

- 3.8 Any assets or liabilities which SLAL and SLIF agree may not be effectively transferred by the Scheme ("Residual Assets" and "Residual Liabilities") shall be retained by SLIF on behalf of SLAL and may be transferred to SLAL at a subsequent date when the impediment to the transfer has been resolved.
- 3.9 Residual Assets will include an amount in respect of the statutory capital requirement for SLIF immediately after the Effective Date. This amount will be at least equal to the base capital requirement of €3.5 million (and is expected to exceed it by £0.5 million in practice) but if any Excluded Reinsurance Agreements (see 3.10) exist, a larger amount may be required. Once SLIF has been de-authorised as an insurance company and is not required to maintain a capital requirement, this capital will be transferred to SLAL's SHF.

#### Excluded Reinsurance Arrangements

- 3.10 If the transfer of any reinsurance agreements issued by SLIF cannot be effected by the Scheme then those agreements ("Excluded Reinsurance Agreements") and the liabilities covered by them will be retained by SLIF and dealt with (as described in 3.14 below).

### New reinsurance arrangements

- 3.11 The effect of existing reinsurance arrangements between SLIF and the HWPF will be replaced by arrangements between the PBF and the HWPF.
- 3.12 The PBF will be required to make payments to the HWPF equal to the actual annuity outgo of the HWPF (excluding annuities reinsured to Canada Life) less the amounts set out in the schedule of payments and payable to SLIF under the existing arrangement. In return for this reinsurance cover the assets held by SLIF in respect of the existing arrangement will be transferred to the PBF. The effect of the Memorandum of Understanding in relation to the existing reinsurance agreement will be replicated by the Scheme. The Scheme also requires the SLAL Board to provide an alternative arrangement for the reinsurance of the HWPF's longevity risk should the proposed arrangement cease.
- 3.13 The PBF will be designated as a "New Investment Fund" of the HWPF and the property-linked Transferred Assets allocated to the HWPF will be immediately transferred into the PBF by way of an internal arrangement to have the same effect as a reinsurance arrangement.
- 3.14 In the event that Excluded Reinsurance Agreements exist after the Effective Date, SLIF's liabilities under these agreements will be fully reinsured to SLAL (to the fund to which the liabilities would have been transferred). The initial premium, equal to the mathematical reserves held by SLIF in respect of these contracts on the Effective Date, will be met from the Transferred Assets and any subsequent premiums received in respect of these contracts will be remitted to SLAL.

### Internal linked funds

- 3.15 The property-linked Transferred Assets (whether directly allocated to the PBF or transferred under the arrangement to be entered into with the HWPF) will be allocated to the internal property-linked funds maintained or, where an appropriate fund does not currently exist, created, in the PBF.
- 3.16 The Scheme preserves SLAL's right to manage its existing and transferred internal property-linked funds by merger, closure, or amending the investment objectives, or to introduce new internal property-linked funds in the future.

### Provisions of the 2006 Scheme

- 3.17 The provisions made under the 2006 Scheme shall remain in force in all respects, except for the amendments set out below.
- 3.18 The 2006 Scheme provides that, should the SLIF EB Annuities Agreement be terminated "in accordance with its terms", the SLAL Board shall establish an alternative arrangement that has the same economic effect and is not materially less beneficial to the HWPF. The Scheme makes provision for a replacement arrangement to be entered into between the HWPF and the PBF. However, the current agreement will cease to have effect due to operation of law since the reinsurer and the reinsured will be the same rather than in accordance with the agreement's terms (under the terms of the 2006 Scheme). The amendment aims to clarify that the provisions in the 2006 Scheme apply equally when the agreement is terminated due to operation of law. There is a consequential change to the 2006 Scheme to identify that any amount which would be paid to SLAL in the event of the termination of the agreement in accordance with its terms would also be paid if termination is by operation of law.
- 3.19 A further amendment aims to clarify that the RCFs will continue to be calculated as intended by the 2006 Scheme, irrespective of the fund to which the HWPF property-linked funds are allocated. The amendment will also clarify that the fund may be part of an SL Group entity other than SLAL.

### Costs of developing the Scheme

- 3.20 All costs incurred by SLIF and SLAL in relation to the preparation and execution of the Scheme will be borne by the PBF.

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## Miscellaneous aspects of the Scheme

### Termination of the Dublin Loan

- 3.21 The outstanding amount under the Dublin Loan between SLAL and SLIF will be repaid prior to the Effective Date.
- 3.22 The loan documentation does not currently provide for early repayment and will therefore need to be amended before repayment can take place.
- 3.23 SLAL's SHF is expected to subscribe additional capital to SLIF to allow the Dublin Loan to be repaid.

### Policyholder communications

- 3.24 SLIF's policyholders are all authorised insurance companies (and number seven in total, including SLAL and SLPF). Each of SLIF's policyholders has been notified individually of the proposed Scheme as part of the development of the Scheme, and has not indicated objections to its terms. SLIF's policyholders will be provided with the terms of the Scheme and a copy of the summary of the Scheme Report, as well as details of how to object to the Scheme, as required by FSMA.
- 3.25 SLAL is seeking a waiver from the Court in relation to the requirement to notify its policyholders individually of the proposed Scheme. SLAL will publicise its proposals in respect of the Scheme by means of notices to be published in the Gazettes and in three national newspapers. It will make available an outline of its proposals and a copy of the Scheme Report on its website and will provide these to policyholders on request. The contact details for requesting information and details of how policyholders may object to the proposals will also be given in the notices and on the website.

## 4. ASSESSMENT OF THE SCHEME

### Approach

- 4.1 In this section of my report, I will consider the operation of SLAL and SLIF after the Effective Date and the consequential effects of the Scheme on holders of any Excluded Reinsurance Agreements after implementation of the Scheme. I consider the effects of the Scheme on policyholder interests under the headings of:
- security of benefits; and,
  - reasonable benefit expectations.
- 4.2 I have had regard to the Principles for Business Rules in the FSA Handbook (and, in particular, Principle 6, the requirement to treat customers fairly) and the requirements of COBS 20 in conducting this assessment.

### Outline of the post Scheme structure of SLAL

- 4.3 Once the Scheme has been implemented, SLAL will no longer have reinsurance relationships with SLIF but will reinsure some liabilities to the EFMs (being liabilities previously ceded to SLIF and then retroceded to these third parties) and will continue to reinsure liabilities to SLPF (being those currently reinsured to SLPF).
- 4.4 SLAL will receive reinsurance from SLPF and the EFMs. Floating charges will exist in SLAL in favour of these reinsured parties.
- 4.5 The PBF will retain all the new business written and will not reinsure it and it will therefore be required to meet the funding requirements related to that business. The PBF will be exposed to the full longevity risk related to the portion of the HWPF annuity business not reinsured to Canada Life rather than just the longevity tail risk. The PBF will also be the medium for the management of all of the property-linked business written by SLAL or reinsured to it from SLPF or the EFMs.
- 4.6 The SLAL SHF will receive substantially all of the assets of the SLIF SHF and will continue to be able to account for the value of the remainder of those assets. Other than for the short period after the Effective Date until SLIF is de-authorised (since no Excluded Reinsurance Arrangements are expected), SLAL will not maintain double-counted capital requirement in respect of SLIF.
- 4.7 I have considered the extent to which other companies of the SL Group are affected by the Scheme and have concluded that only SLAL and SLIF need be considered directly in the Scheme Report. SLPF is considered indirectly as a policyholder of SLIF. SLAL's other subsidiaries are unaffected by the Scheme.

### Security of benefits

#### Approach to assessment

- 4.8 The security of policyholders' benefits is principally related to the extent to which the value of the assets exceeds the value of the liabilities and this requires consideration of both the Pillar 1 and Pillar 2 positions. The published Pillar 1 position shows SLAL's solvency position from a statutory solvency perspective. In considering the effects of the Scheme, I have also considered the Pillar 2 position and whether there is a significantly different exposure to risk as a result of the Scheme being implemented.
- 4.9 I also have had regard to the implications of the proposed implementation of the Solvency II regime.

#### Pillar 1 considerations

- 4.10 On the implementation of the Scheme, SLAL will receive all of the long term liabilities and assets transferred from SLIF. The pro-forma financial position of SLAL had the transfer occurred at 31 December 2010 is shown in the following table. For the purpose of this table, the line shown as "Reinsurance" includes reinsurance ceded from SLAL (under current and transferred-in contracts) and the internal transfer of liabilities between the HWPF and the PBF. The CRR has been calculated by

combining the elements of the CRR for each of SLAL and SLIF and ignoring any benefits which may arise from applying the calculation with the IGR arrangements and redundant capital requirements removed. SLIF's RCR is excluded since SLAL does not need to hold capital under this heading.

£million	HWPF	PBF	Other LTF	Total
<b>Admissible Assets</b>	<b>44,121</b>	<b>61,880</b>	<b>519</b>	<b>106,520</b>
Gross Liabilities	75,761	92,139	481	168,381
Reinsurance	(42,627)	(31,048)	0	(73,676)
Net Liabilities	33,133	61,091	481	94,705
Other Liabilities	6,998	468	5	7,471
<b>Total Liabilities</b>	<b>40,131</b>	<b>61,559</b>	<b>486</b>	<b>102,176</b>
Excess Assets	3,990	321	33	4,344
Shareholders' Fund	-	-	-	2,491
<b>Total Capital Resources (A)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>6,835</b>
LTICR	-	-	-	1,737
RCR	-	-	-	N/A
WPICC	-	-	-	1,122
BCRR	-	-	-	N/A
<b>Capital Resources Requirement</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,859</b>
ICRR - other subsidiaries	-	-	-	33
<b>Capital Resources Requirement (B)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,892</b>
<b>CRR Cover (A/B)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>236%</b>
Dividend	-	-	-	300
<b>CRR Cover, post dividend</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>226%</b>

Source: SLAL FSA Returns 31 December 2010

- 4.11 This shows that SLAL's post-transfer regulatory capital cover would have been 226% and that SLAL would have therefore comfortably met its Pillar 1 regulatory capital requirements and that there would have been little change in the level of cover provided in SLAL (221%, see the table in 2.57) or SLIF (215%, see the table in 2.102) on that date. In practice, the redundancy in the calculation of the CRR created by maintaining two companies would have provided some improvement to the capital cover position.
- 4.12 It can also be seen (by reference to the table in 2.57) that the net position in the HWPF before considering its capital requirements would have been unchanged on the implementation of the Scheme.
- 4.13 I have also been provided with updated information showing the pro forma position had the Scheme become effective as at 30 June 2011, and this indicates that the financial position would not have been materially different at that date.

## Pillar 2 considerations - risk based assessment

- 4.14 Under the current reinsured arrangements, SLIF reinsures the property-linked business in the HWPF and the part of the HWPF annuity business that is not currently reinsured to Canada Life. SLIF also accepts the risks related to the PBF's and SLPF's new business. SLAL has counterparty risks from the reinsurance arrangements although these are largely mitigated by the floating charges. SLAL's PBF carries a stop loss cover on the HWPF annuity reinsurance with SLIF and so is exposed to the extreme tail risks that could arise on that business. Therefore SLAL's capital position is heavily influenced by that of SLIF.

- 4.15 The available capital resources in SLAL are a combination of SLAL's directly held assets and those of SLIF, and these latter resources are reduced by the capital requirements of SLIF. SLIF's capital position is driven by the new business transacted in the PBF and, to a lesser extent, in SLPF.
- 4.16 It could be expected that SLAL's risk based capital position assessed under the ICA test would be better than would have applied if the Scheme was not implemented, since the risks are not separated by the boundaries of the limited companies and may be more efficiently diversified and offset by the total capital available. However, any improvement is not expected to be material.
- 4.17 Since SLIF has no direct policyholders, the vertical nature of the structure means that there is no particular protection offered to SLAL policyholders by SLIF being a separate limited company. SLAL policyholders would look to SLAL to meet their benefits and, in the event of SLAL failing, would be no better protected by the existence of the reinsurance arrangement than if the assets were held directly (whether SLIF had failed at the same time or not). Consequently, in my opinion, there is likely to be little difference to the security of the SLAL policyholders' benefits after the implementation of the Scheme.
- 4.18 SLIF also reinsures the property-linked liabilities of SLPF and certain other EFMs. The nature of the liability means that there are limited risks to SLIF arising from this business and these are largely related to the recoverability of charges due to market risks or persistency being lower, and expenses being higher than expected. These risks will be transferred to SLAL. The operational risk to which SLIF is currently exposed will also be taken on by SLAL after the Effective Date but the impact of this will be minor since SLAL will have indemnified SLIF for much of this exposure. To the extent that SLIF remained exposed to the first £1 million of operational risk costs, this would have had a direct impact on the carrying value of SLIF in SLAL's SHF if such an event had occurred. I do not consider that the increased direct risks in SLAL after the Effective Date are likely to have a material impact on SLAL's circumstances since the impact of such risks would have emerged in SLAL in any event in the value that was placed on SLIF by SLAL.
- 4.19 SLPF and the EFMs reinsured to SLIF will become exposed to a much wider range of risks after the transfer to SLAL (e.g., with-profits business and the tail risks of the annuity business). Although they will lose the protection afforded by SLIF being a separate limited company, their interests will be protected in that the floating charge that currently provides them with protection in SLIF will be replicated in SLAL so that the value of the protection provided will be largely unaffected.
- 4.20 It is noted that, since the floating charge only encumbers SLAL's property-linked assets up to the value of the reinsured property-linked benefits, it does not impose an additional threat to the security of SLAL's policyholders, whether or not they are invested in the same property-linked funds as the reinsured benefits.
- 4.21 SLPF also reinsures annuity business to SLAL and is not protected by the non-linked floating charge on SLIF currently nor will it be under the new floating charge in SLAL. SLPF is therefore exposed to the risk of not being a preferred creditor on winding up. I do not believe that the risks imposed by this will be any greater on the implementation of the Scheme as SLAL is no more likely to become insolvent after the Effective Date than before it. SLPF's policyholders would look to SLPF to provide for their benefits in either case.
- 4.22 Overall, the risks to which SLAL's policyholders are exposed will not change materially after the Scheme is implemented.

#### Effect of SLAL's fund structure

- 4.23 In normal circumstances, each of the funds of SLAL will operate without recourse to any other funds, but in extreme circumstances, these protections break down if solvency is threatened. In these circumstances all of the assets would become generally available to meet the liabilities and would not be ring fenced for specific classes.
- 4.24 The current property-linked business floating charge will be amended so that SLAL will be the chargor and SLPF and the EFMs will be beneficiaries. The scope of the property-linked floating charge will be amended to apply to the reinsured proportion of SLAL's property-linked assets related to its UK and Irish business. The reinsured proportion will be the ratio of the value of the benefits reinsured from SLPF and the external reinsured parties to the value of the property-linked funds on the relevant date.

The default event which would trigger the floating charge will be defined as it is currently but by reference to SLAL rather than SLIF.

- 4.25 The aim of this change is to secure assets to meet the value of the reinsured liability. This does not require that the reinsured benefits would be satisfied by the assets which may have been attributed to the funds in which the reinsured benefits had been invested immediately prior to the default. Whilst it may be reasonable to expect that there would be a good match between the charged and the recaptured assets, this may not be so if there are particular features of the assets of the reinsured funds which make them more difficult to transfer from SLAL. However, it also appears to be the case under the current arrangement that SLPF and the EFMs would not necessarily recover the assets in which the reinsured funds had been invested.
- 4.26 The HWPF will not retain any of the risks that it currently reinsures to SLIF as these will be “reinsured” to the PBF. The HWPF will no longer benefit from the floating charges which currently apply in SLIF since these will not be replicated in SLAL for these benefits. As already noted the current arrangements would only be advantageous to policyholders directly as long as SLAL was not in default. If SLIF defaulted currently, then SLAL would receive a share of its assets. After the Scheme has been implemented, SLAL will hold those assets directly. In either case, the assets would comprise part of the general pool available rather than being directly attributable to SLAL’s individual property-linked policyholders. Since SLAL is no more likely to default after the Scheme has been implemented, the effect is immaterial.
- 4.27 The PBF will be the “counterparty” for the internal transfer from the HWPF. The business which will be transferred to the PBF is relatively low risk. The most significant risk being transferred to it would ordinarily relate to the annuity business where longevity and credit risks are recognised. However, the risk of longevity being much lighter than expected is already reinsured to the PBF but the PBF will now also be exposed to the full longevity risk as the portion which previously fed directly from SLIF to the SHF will lie in the PBF. Ultimately the risk exposure for both elements of the longevity risk lies with the SLAL SHF before and after the Effective Date. The overall effect on SLAL is neutral.
- 4.28 The PBF will also be subject to the direct risks of transacting new business which are currently reinsured to SLIF. However, although this will change some of the financial dynamics of the PBF, it will not change the fact that the PBF would be affected currently if SLIF were to default. That position will not alter after the Scheme has been implemented. Therefore, the risk that the PBF may prove insufficient is unlikely to be materially different from the risk that SLIF would fail currently. The exposure of the HWPF to the effects of, and risks related to, the transaction of new business would be similar before and after the implementation of the Scheme since ultimately the economic interest in the new business and the provision of capital to fund it lies with SLAL.
- 4.29 The UKSWPF, the GSWPF and the GWPF currently neither accept nor cede reinsurance with SLIF and none of the terms relating to the management of these funds will be altered. Since I do not consider the overall security of SLAL to be materially affected by the implementation of the Scheme, the security of these funds is unaffected by the Scheme.
- 4.30 The security of the minority holdings of Canadian business within SLAL will be unaffected by the Scheme by virtue of the fact that it is wholly reinsured to SLACC, and will continue to be post-transfer.

## Capital management

- 4.31 The implementation of the Scheme will remove some redundancy in the CRR calculation and will also allow some capital to be recognised more appropriately within the statutory financial statements. The application of the SL Capital Management Policy may mean that there is a greater ability for capital to be released from SLAL after the implementation of the Scheme whilst continuing to meet the requirements of the Capital Management Policy.

## Solvency II

### General background

- 4.32 A new system of regulation for insurance companies is planned to come into effect in January 2013 (but the introduction may be delayed). Solvency II will require significant changes to be made to the way in which insurance companies are managed and will introduce a radically different approach to

reserving and capital requirements from the current Pillar 1 regime. A brief outline of structure of Solvency II is set out in Appendix 4. Solvency II is not solely an exercise in capital management and firms will need to undertake a wide-ranging review of the way in which they conduct their affairs to ensure compliance with the Directive.

- 4.33 The final requirements of Solvency II have not been fully defined at the date of this report. There are a number of draft technical standards that may not be available until after the implementation date for Solvency II. In particular, the factors which will be used to determine the capital requirements for firms applying the standard formula approach have not been finalised. A company may apply to have an internal model approved if that better describes the risks to which the company is exposed. Using the standard formula does not mean that companies need not allow fully for the actual risks and an Own Risk and Solvency Assessment ("ORSA") will be required as a test of the general suitability of the standard formula.
- 4.34 Solvency II will represent a material change in the regulation of insurance companies across Europe and many companies will struggle to implement its requirements in the timescale, particularly given the current uncertainty regarding certain key elements. As a result there are likely to be transitional arrangements adopted to allow an orderly adoption of the Directive's requirements. The transitional arrangements are also part of the continuing discussions but neither the duration nor the scope has been determined at the date of this report. There is also uncertainty over the jurisdictional application, so it is possible that the UK may or may not be able to enforce faster transitional arrangements than other EU member states or have no such arrangements. For the purpose of considering the effects of Solvency II, I have ignored the transitional arrangements.
- 4.35 Solvency II will require firms to have in place:
- a risk management framework, including policies and practices to identify, monitor, manage and mitigate the risks to which the company is exposed;
  - appropriate management and governance arrangements to apply the requirements of the risk framework and to give oversight to its application;
  - a procedure to determine best estimate technical provisions, risk margins and solvency capital requirements (whether by the standard formula or by the use of an internal model); and,
  - adequate capital resources of sufficient quality.

#### **Application to SLAL**

- 4.36 It is beyond the scope of this report to address the detail of the implementation plans that have been prepared by SLAL. However, it is appropriate to include commentary in the Scheme Report on the general implications and requirements of Solvency II as it will affect the enlarged SLAL after the Effective Date and whether these are materially different from those for the companies separately. In the event that the Scheme does not proceed then SLIF would be subject to the requirements of Solvency II also.
- 4.37 Many of the features of Solvency II will represent an evolutionary step for UK insurance firms since the ICA process which has applied for some years has a similar approach and requires a similar governance arrangement to ensure that the assessment of risk is "embedded in the business". However, Solvency II will impose a significantly higher burden on companies and their managements to ensure compliance with the Directive's requirements.
- 4.38 I have been provided with a description of SLAL's implementation plan, and whilst I have not undertaken a detailed review to check its adequacy and robustness (e.g., in terms of timetable, resourcing and budget), I am comfortable that it addresses the key areas in an appropriate way.
- 4.39 Solvency II relates not just to the calculation of capital requirements but to the whole approach adopted for the management of the business in line with an appropriate risk policy and framework (as set by the business). SL has established a project plan for the implementation of Solvency II to ensure that it meets all of the requirements by the earliest implementation date in 2013. This plan includes the establishment of an "internal model" approach which is intended to cover all of SL's European and Canadian insurance business. SL is participating in the internal model pre application process being run by the FSA which is intended to help firms gain the necessary approval by the date

that Solvency II is implemented. The company remains on target to complete the internal model in line with the timetable set out in the proposal.

- 4.40 The implementation of Solvency II will be slightly simpler for SL if the Scheme is implemented as only one internal model will be required rather than two for the business included in SLAL and SLIF and the challenges of combining the separate outputs at the Group level will be avoided and capital management will be improved.
- 4.41 The internal model calculation kernel is still in the process of development but SL has undertaken test calculations of the impact of Solvency II on the basis of the current specification standard formula as set out in the Fifth Quantitative Impact Study ("QIS 5") and also considered the results in the context of its ICA. This suggested SLAL would comfortably satisfy its capital requirements and would do so even if some of the favourable elements of the specification tested in QIS 5 did not finally apply under Solvency II.
- 4.42 The internal model may produce a lower capital requirement than the standard formula but, whether or not this is the final outcome, it is noted that the use of the internal model will result in an enhanced risk management process which should be beneficial for policyholders. Although SLAL intends to apply the internal model approach this requires SLAL to gain regulatory approval for the procedures it plans to adopt and the calibration and calculation methods used to determine its capital requirements. If approval is not obtained for the model or if the scope of the approval is less than anticipated, then SLAL would by default be subject to some or all of the standard formula approach which would create some uncertainty in its capital planning in the run-up to Solvency II.
- 4.43 The implementation of the Scheme will be beneficial to the overall Solvency II position if the proposed rules on intra-group reinsurances as they apply to the standard formula are adopted as these would produce unduly onerous capital requirements. The Scheme effects a significant reduction in intra-group reinsurance exposure and therefore removes the risk that SLAL will have to provide significantly more capital than it considers to be appropriate.
- 4.44 It is also pertinent to note that there may be transitional arrangements to allow companies to adapt to the new regime, and this may give SLAL some further scope to make further changes to its capital or risk exposure.
- 4.45 In my opinion, the Scheme will remove some uncertainty from the determination of the amount of capital required by SLAL on the implementation of Solvency II and is likely to be beneficial to the management of SLAL.

#### Excluded Reinsurance Arrangements

- 4.46 The security of the benefits under Excluded Reinsurance Arrangements will be maintained by means of the reinsurance arrangement which will be required between SLIF and the PBF. Excluded Reinsurance Arrangements are not expected to occur but terms of this nature are typically included within transfer schemes to provide certainty in the treatment of any policies which cannot be transferred as expected. In the event that Excluded Reinsurance Arrangements do arise, the benefit afforded by the floating charge will extend to SLIF and it will rank alongside SLPF and the EFMs as described in 4.23 above.

#### Conclusion on security of policy benefits

- 4.47 **In my opinion, the security of the benefits of Transferred Reinsurance Arrangements, Excluded Reinsurance Arrangements and existing SLAL policies will not be materially affected by the implementation of the Scheme.**

#### Policyholders' reasonable benefit expectations

- 4.48 In this section of the Scheme Report, I consider whether the implementation of the Scheme is likely to change the benefit expectations of SLAL's policyholders or any of the holders of the Transferred Reinsurance Agreements.
- 4.49 The policies of the PBF are mainly non-profit or property-linked in nature and their terms are either largely fixed or, if variable, will be subject to limited discretionary powers available to SLAL. Benefits

under property-linked contracts will be dependent on the performance of the underlying property-linked funds and this is unlikely to change simply as a result of the implementation of the Scheme. Where the charges imposed on contracts may be varied in the future, these should be no higher than those that would have arisen in the absence of the Scheme as there is no change to the overall administration of them. If anything, costs should be slightly lower, since there will be one less company and layer of complexity in the structure.

- 4.50 The management of the internal property-linked funds will not alter on the implementation of the Scheme although SLAL will retain the power to merge or close funds or introduce new funds in the future. There should be no change to the value of property-linked assets allocated to policyholders simply as a result of the Scheme being implemented.
- 4.51 The policyholders of the UKSWPF, the GSWPF and the GWPF are unlikely to see any changes to their benefit expectations since none of the terms of the Scheme directly impact upon these funds and the funds are intended to be managed within their own resources without reliance on any other funds of SLAL. To the extent that the costs incurred may be lower, as suggested above, there may be a possibility of some improvement in expectations.
- 4.52 The arrangements which apply to the HWPF will exactly mirror the current arrangements in their effect (apart from future payments of a sum assured on death, in lieu of which the HWPF will receive assets equal to the prudential statutory reserve from SLIF to maintain equivalence with the current position). The PPFM (and the 2006 Scheme) established a framework for the management of the HWPF and those requirements will not change. In setting the investment policy for the HWPF, the Notional Company should be used. Although the Notional Company structure must be used as a reference, SLAL does not need to hold capital exactly in that format but will have to hold sufficient capital nonetheless to allow for the investment risk which the Notional Company invokes. I have considered whether the Scheme would affect SLAL's ability to fund this capital requirement. Overall, it does not appear that this should be materially affected, since the SHF will remain the primary source of capital to fund the new business strains which will arise in the PBF (rather than in SLIF). In addition, profits transferred from the HWPF for the benefit of the shareholders may be allocated to the PBF and therefore be available to offset such strains in the first instance. As a result, in my opinion, the implementation of the Scheme is unlikely to impact upon the requirements imposed by reference to the Notional Company.
- 4.53 I have been informed that the arrangement which is used by SLAL currently to post collateral in respect of derivative positions is such that gilts held by the HWPF are deposited with the counterparty, irrespective of the fund which is the beneficiary of the derivative position. In SLIF, a similar arrangement currently applies using gilts from an internal property-linked fund whether or not that fund is otherwise a party to the derivative position. After the Scheme has been implemented, if no other action was taken, gilts in the HWPF would be used to provide the collateral for any derivative positions relating to the transferred business as well as the business currently retained by SLAL. This could mean that assets may not be recognised in the correct pool for the purposes of applying the floating charge in the remote chance that it was triggered. The effect of the Scheme will be to exacerbate the risk (whilst recognising that the risk itself is small) and SLAL intends to monitor the level of exposure and will take appropriate action should the issue become material. The alteration to this practice may have been triggered by the implementation of the Scheme but, in my opinion, it is incidental to the Scheme and policyholders could not readily claim that the amended position unfairly affected their interests.

#### Effects of the floating charge of benefit expectations

- 4.54 In the event that SLAL failed after the Effective Date, the floating charge provides protection to the reinsured parties as they would otherwise rank behind the direct policyholders of SLAL in a liquidation process. The assets covered by the floating charge are defined to provide the reinsured parties with resources up to the amount of the reinsured liabilities (except for certain costs which would arise if the charge was triggered). In the absence of the charge, in the event that SLAL became insolvent, all of its assets would be applied to meet all of its liabilities irrespective of the fund to which either the assets or the liabilities were allocated. This would define the proportion of the liabilities which could be met from the available assets. The effect of the floating charge is to determine the amount to be subject to the charge by reference to the proportion of the property-linked liability which relates to the insured business and would not have regard to the circumstances of other parts of SLAL. This could result in

the reinsured parties receiving a greater proportion of the reinsured liability than the proportion applicable to other policyholders in those circumstances.

- 4.55 I consider this to be an immaterial risk since, as I have noted in 4.10, SLAL is well capitalised and maintains an appropriate capital policy so that the trigger for the floating charge applying is remote. I also note that the nature of the reinsured business would suggest that it would be unlikely that it would be responsible for SLAL getting into difficulties. Additionally, the value of the assets available to SLAL's direct policyholders in these circumstances would be broadly the same as would have applied if the reinsurance arrangement had not been in place.
- 4.56 In my opinion, the floating charge on the assets of SLAL which will be required on the implementation of the Scheme is unlikely to have a materially adverse effect on the benefit expectations of SLAL's policyholders.

#### Excluded Reinsurance Arrangements

- 4.57 Benefits under Excluded Reinsurance Arrangements will be maintained by means of the reinsurance arrangement which will be required between SLIF and the PBF. Excluded Reinsurance Arrangements are not expected to occur.

#### Conclusion on benefit expectations

- 4.58 **In my opinion, the implementation of the Scheme is unlikely to have a material effect on the reasonable benefit expectations of SLAL's policyholders or in respect of the Transferred Reinsurance Arrangements and the Excluded Reinsurance Arrangements.**

#### Miscellaneous aspects of the Scheme

##### Alterations to the 2006 Scheme

- 4.59 The Scheme proposes an amendment to the 2006 Scheme to clarify the consequences of the SLIF EB Annuities Treaty terminating by operation of law rather than in accordance with its terms as anticipated in the 2006 Scheme. The changes proposed are to ensure that new arrangements must be introduced on termination of the Treaty in such circumstances to provide similar protection to that provided by the SLIF Annuities Treaty, and to clarify that any payments which would have been made on termination in accordance with the terms of the Treaty will also be made on termination by operation of law. (The Scheme includes terms for the introduction of equivalent "reinsurance" arrangements between the HWPF and the PBF, in satisfaction of the former requirement.) The purpose is thus to ensure that the interests of the HWPF and SLAL's shareholders remain unchanged by the Scheme in respect of the management of SLAL.
- 4.60 The 2006 Scheme created a mechanism to allow the release of the profits on defined blocks of business in the HWPF to shareholders but imposed constraints so that capital protection could be given. The application of this mechanism will be clarified to reflect the fact that the new arrangement between the HWPF and the PBF has the appearance of being reinsurance but it is not in legal terms. Since the 2006 Scheme specifies that reinsurance other than with SLIF under the current agreements should be allowed for in determining the RCF, the terms of the 2006 Scheme are being amended to permit flexibility in the management of the RCF in the light of any future intra-group reinsurance arrangements affecting the defined blocks of business in the HWPF.
- 4.61 The proposed changes to the 2006 Scheme are both necessary and sufficient to clarify the position under the Scheme and to ensure that the original intentions of the 2006 Scheme are not breached inadvertently. The changes which are proposed are unlikely to create additional payments to shareholders or to alter the pace at which transfers may be made (or the contingent loan to be paid off).

#### Administration and service standards

- 4.62 The current servicing and administrative arrangements relating to the business of SLAL and SLIF (and SLPF) are integrated through the common provision of services. Whilst there may have been some notional distinction between the arrangements for direct business and the reinsured business, in

practice this has been largely to identify charging arrangements. Consequently I do not expect that the implementation of the Scheme will adversely affect the servicing standards for policyholders.

- 4.63 Since the administrative arrangements will continue to be provided through the current outsourced arrangements, there is unlikely to be an increase in the costs of administration solely as a result of implementing the Scheme, and there may actually be a small reduction in the overhead costs of maintaining separate companies.

### Costs

- 4.64 The costs of developing and implementing the Scheme will be borne by the PBF (and consequently will in effect be borne by shareholders). The costs will not be re-allocated to policyholders and there will therefore be no direct impact on policyholders' benefits from this source.

### Third party contracts

- 4.65 All third party contracts maintained by SLIF will be transferred to SLAL and their terms will be unaltered. The interests of the third parties will be unaffected.

### Communications with policyholders

- 4.66 SLIF intends to inform all of its policyholders of the proposed Scheme. This will not be onerous since in practice SLIF has only seven policyholders which include SLAL and SLPF. These policyholders have already been notified of the proposed changes which will be effected by the Scheme and no objections to the Scheme have been recorded from them. They have not had sight of my conclusions on the terms of the Scheme as set out in this Scheme Report they will be provided with a copy in due course, as required by FSMA.
- 4.67 SLAL intends to seek a waiver from the Court so that it will not be required to inform its policyholders individually of the terms of the Scheme. Since the proposed changes remove arrangements of which policyholders are probably unaware, and do not change materially the security of benefits (see 4.47), the risks to which policyholders are exposed (see 4.22) or the benefit expectations of SLAL's policyholders (see 4.58), I do not believe that SLAL's policyholders will be disadvantaged by not being informed individually of the nature of the changes proposed.
- 4.68 In support of its application for this waiver, SLAL has drawn attention to the fact that the costs of mailing each of its 4.4 million policyholders individually would be significant (on the basis of £1 per policyholder). This amount would not be material in the scale of the SL Group's operations but, whilst it would not directly affect policyholders, it would reduce the available capital in SLAL slightly. In addition, it is likely that the timetable for implementing the Scheme would be affected if all policyholders were to be notified and, as a result, SLAL would not achieve some of the benefits from implementing the Scheme in 2011. Whilst these matters are relevant to the consideration of SLAL's application, they are less compelling than the reasons set out in 4.67.
- 4.69 I believe that the alternative arrangements proposed by SLAL to advertise the transfer widely in the UK press and to display the documents relating to the Scheme (including this Scheme Report and its summary) on its website are reasonable and appropriate in the circumstances.

### Tax consequences of the Scheme

- 4.70 There are not expected to be any adverse tax consequences on implementing the Scheme.

### Treating customers fairly

- 4.71 The changes proposed under the Scheme are mainly structural to the capital management of SLAL and SLIF and do not directly impact upon the fair treatment of customers. However, I believe that SLAL and SLIF have had appropriate regard for the interests of policyholders in developing the Scheme to ensure that the security and benefits of its policyholders have been maintained and that their reasonable information needs will have been met.

### Consequences of the Scheme not proceeding

- 4.72 If the Scheme does not proceed, the current reinsurance arrangements will stay in place and there will be no change to the operational arrangements. SL may not achieve the capital efficiencies that it would have gained under the Scheme.

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## 5. SUMMARY OF CONCLUSIONS

In summary, in my opinion, on the implementation of the Scheme,

- the security of the benefits of Transferred Reinsurance Arrangements, Excluded Reinsurance Arrangements and existing SLAL policies will not be materially affected; and,
- there is unlikely to be a material effect on the reasonable benefit expectations of SLAL's policyholders or in respect of Transferred Reinsurance Arrangements and Excluded Reinsurance Agreements.



J.L. McKenzie

Fellow of the Institute and Faculty of Actuaries

London

24 October 2011

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## 6. CERTIFICATE RELATING TO THE CHANGES TO THE 2006 SCHEME

- 6.1 In this section, I also provide the certificate required under the 2006 Scheme which must be provided to the Court in support of the changes to be made to the 2006 Scheme.
- 6.2 I have considered (in 4.59-4.61) the changes which are proposed to be made to the terms of the 2006 Scheme and consider that these are such as to clarify the application of the 2006 Scheme in the circumstances of the current Scheme. The changes are reflective of the intentions of the 2006 Scheme and in practice will result in the same outcome as would have occurred in the absence of the current Scheme.
- 6.3 I certify that in my opinion the changes proposed to the 2006 Scheme will not materially or adversely affect the interests of SLAL's policyholders transferred from SLAC under the terms of the 2006 Scheme.



J.L. McKenzie  
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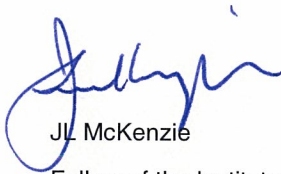
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## 7. CERTIFICATE OF COMPLIANCE

- 7.1 I understand that my duty in preparing this report is to help the Court on all matters within my expertise and that this duty overrides any obligations I have to those instructing me and / or paying my fee. I confirm that I have complied with this duty.
- 7.2 I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.

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J.L. McKenzie

Fellow of the Institute and Faculty of Actuaries

London

24 October 2011

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**APPENDIX 1 – TERMS OF REFERENCE****Schedule 1****GENERAL REQUIREMENTS**

1. It is the Independent Expert's duty to help on the matters within his expertise. This duty is paramount and overrides any obligation to the person from whom he has received instructions or by whom he is paid.
2. Evidence presented to the Court should be, and should be seen to be, the independent product of the Independent Expert uninfluenced by the exigencies of the instruction or Court proceedings.
3. The Independent Expert should provide independent assistance to the Court where appropriate, by way of objective unbiased opinion in relation to matters within his expertise. He should never assume the role of an advocate.
4. The Independent Expert should not omit to consider material facts within his knowledge which could detract from his concluded opinion.
5. The Independent Expert should make it clear when a particular question or issue falls outside his expertise.
6. If the Independent Expert's opinion is not properly researched because he considers that insufficient data is available, then this must be stated with an indication that the opinion is no more than a provisional one.
7. In a case where the Independent Expert who has prepared a report could not assert that the report contained the truth, the whole truth and nothing but the truth without some qualification, that qualification should be stated in the report.
8. If the Independent Expert changes his view on a material matter having read another expert's report or for any other reason, such change of view should be communicated in writing (through legal representatives) without delay, and when appropriate to the Court.

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## Schedule 2

### SCOPE OF THE WORK OF THE INDEPENDENT EXPERT IN RELATION TO THE SCHEME

My report is to consider the terms of the Scheme generally and the effect which the Scheme will have on the holders of long term policies of the SLAL and SLIF.

In particular my report will consider the following specific matters:

- The impact of the Scheme on the security of the different groups and generations of policyholders of the Companies involved in the Scheme;
- a review of, and opinion on the fairness of, the terms that apply to any transfers of non-profit policies from with-profits funds to the extent that such transfers are included in the Scheme;
- a review of, and opinion on the fairness of, proposals to combine any with-profits funds to the extent that any such combinations are included in the Scheme (either as at the Effective Time or subsequently), and consideration of any further covenants or undertakings that may be required to ensure that each category of policyholder is treated fairly;
- a review of, and opinion on the fairness of, any mechanisms to be implemented at the same time as the Scheme, but not included in the Scheme, to provide financial support to any of the Companies' funds; and,
- a review of the Capital Management Policy to be adopted by the Companies following implementation of the Scheme.

My review and report will address generally the way in which the Companies have conducted their long term business but taking into account the particular circumstances of each class of business to be transferred. It will deal, inter alia, with the following aspects:

- Memorandum, and the Articles of Association, at least insofar as these affect the rights, expectations and interests of policyholders;
- the terms of the policies issued by each of the Companies;
- promotional or marketing materials (including those documents issued under the Financial Services and Markets Act 2000 and previous compliance regimes) which would influence the reasonable expectations of policyholders;
- the existing and proposed internal working arrangements relating to the financial management of the long term business fund, including the operational and administrative arrangements which will apply to the policies to be transferred under the terms of the insurance scheme;
- the terms and conditions expected to be imposed by the Scheme to be presented to the Court, including the views expressed by the governing body or management of each of the Companies; and,
- the terms of the previous Schemes of transfer concerning the policyholders of the Companies.

The above list is not intended to be exclusive to any other aspects which may be identified during the completion of the project and which are considered to be relevant.

I will not be directly involved in the formulation of the proposed transfer although I should expect to give guidance during the evolution of the detailed proposals on those issues which concern me, or which I consider unsatisfactory.

## APPENDIX 2 – SLAL PILLAR 1 PEAK 2 SOLVENCY POSITION

£m	
Regulatory value of assets	39,188
Excess realistic assets of subsidiaries held in fund	0
Implicit items allocated to the fund	0
Present value of future profits on non-profit insurance contracts	1,378
<b>Realistic value of assets of fund</b>	<b>40,566</b>
<b>With-profits benefit reserve</b>	
<b>30,438</b>	
Past miscellaneous surplus attributed to WPBR	0
Past miscellaneous deficit attributed to WPBR	0
Planned enhancements to WPBR	972
Planned deductions for guarantees, options and smoothing	1,028
Planned deductions for other costs chargeable to WPBR	816
Future costs of contractual guarantees (other than financial options)	1,650
Future costs of non-contractual commitments	684
Future costs of financial options	100
Future cost of smoothing	-236
Financing costs	4
Other liabilities related to the duty to treat customers fairly	0
Other long-term insurance liabilities	1,381
<b>Future policy related liabilities</b>	<b>2,711</b>
<b>Realistic current liabilities</b>	<b>7,416</b>
<b>Realistic value of liabilities of the fund</b>	<b>40,566</b>
Value of relevant assets before applying the most adverse scenario	40,566
Risk capital margin for fund	0
Realistic excess capital for fund	0
<b>Working capital for fund</b>	<b>0</b>
<b>Working capital ratio</b>	<b>N/A</b>

Source: SLAL FSA Returns 31 December 2010

## APPENDIX 3 – SUMMARY OF THE UK REGULATORY REGIME FOR LONG TERM INSURANCE BUSINESS

### Background

1. Financial services in the UK are regulated by the Financial Services Authority (“FSA”). One of the main focuses of the regulator is to ensure that insurance companies remain solvent. Most of the reporting requirements of life insurers are aimed at demonstrating solvency. As well as the usual financial reporting required for all companies insurers also have to submit annually a detailed set of forms and text to the FSA. These FSA Returns are public documents. The FSA also requires other regular submissions to it which are private.
2. Insurance regulation is driven by a number of legislative and regulatory factors including, European Insurance Directives, UK Acts of Parliament and Statutory Instruments. The FSA’s regulations are detailed in the FSA Handbook and in particular the Integrated Prudential Sourcebook.

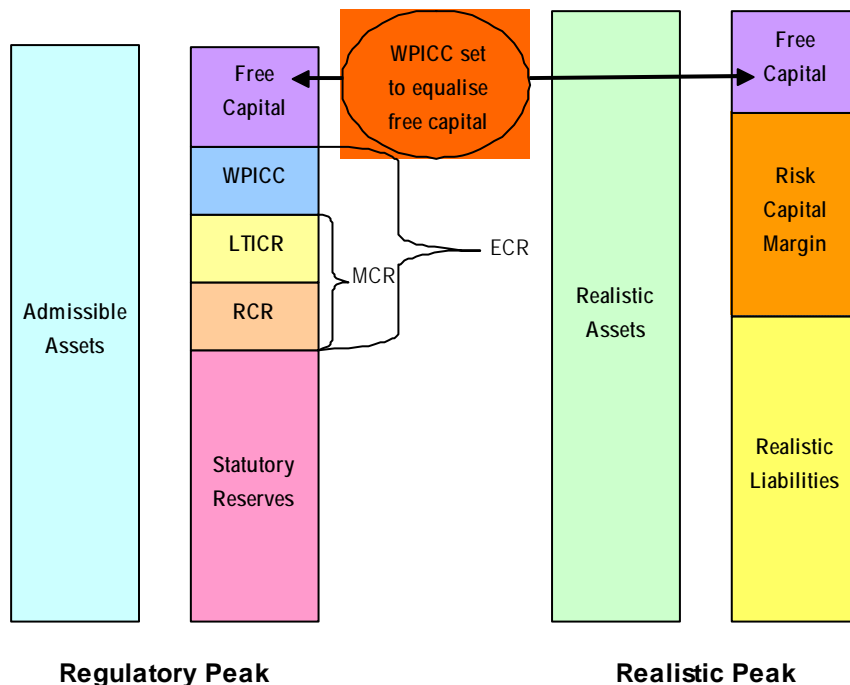
### Capital Resource Requirements, Twin Peaks and Three Pillars

3. The FSA has a number of measures and requirements for the solvency and capital strength of life insurance companies. The overarching concept is of three pillars to regulation. Pillar one is based on prescriptive regulation. The FSA requires a company, if it has significant with-profits liabilities, to calculate its Pillar One requirements two ways, to give results termed Peak 1 (the Regulatory Peak) and Peak 2 (the Realistic Peak), this approach is termed the Twin Peaks approach and is detailed below. Pillar Two requires firms themselves to calculate their capital needs, their Individual Capital Assessment (“ICA”). ICAs are discussed below. Pillar Three is related to market discipline and is not discussed further.

### Capital Resources

4. Firms must at all times maintain Capital Resources at least equal to their Capital Resource Requirements (“CRR”). Capital resources are considered in this section and the CRR in subsequent sections.
5. The FSA categorises capital in different Tiers which reflect the different characteristics of capital and its varying quality. The lower the Tier of capital the higher it's perceived quality. The FSA prefers firms to hold higher quality capital and limits apply to the proportions of lower quality capital a firm can hold.
6. Tier one capital (“T1C”), the highest quality Tier, is permanent and is able to absorb losses. T1C has no fixed costs and consequently no inescapable obligation to pay dividends or interest. T1C ranks for repayment upon winding up after all other debts and liabilities. T1C is itself split into: Core T1C, e.g. permanent share capital, the fund for future appropriations; perpetual non-cumulative preference shares; and innovative T1C, T1C which is redeemable at the option of the firm. There is no limit on the proportion of a firm’s capital contributed by core T1C.
7. Tier two capital (“T2C”) is capital which does not meet the requirements for permanency and the absence of fixed servicing costs. Upper T2C consists of capital which is perpetual, but cumulative, e.g. cumulative preference shares. Capital which is not perpetual or which may have fixed servicing costs that cannot be waived or deferred, e.g. fixed term subordinated debt and dated capital instruments, is included in lower T2C. Limits apply on the proportion of a firm’s capital resources can be T2C.
8. In calculating its capital resources a firm must deduct a number of items, e.g. intangible assets, investments in own shares and inadmissible assets, from the total of T1C, T2C and any other capital resources to arrive at its total capital resources after deductions. There are various limitations on the quality of capital than can be used to meet the requirements of the components of the CRR.

**Components of the Twin Peaks**



**Pillar 1 Peak 1 – The Regulatory Peak**

9. The regulatory peak uses traditional deterministic methods and includes margins for prudence in valuing liabilities. Assets are valued at the more prudent of their bid or offer price. Only defined asset types are allowed and for most asset types there are varying limits on the percentage of the liabilities that can be held in any specific asset type.
10. The CRR for a life insurer that has sufficient with-profits business is the greater of its Minimum Capital Requirement (MCR) and its Enhanced Capital Requirement (ECR).
11. The MCR is the greater of:
  - the base capital resources requirement for long term business; and,
  - the sum of:
    - i. the Long Term Insurance Capital Requirement (“LTICR”), typically a percentage of reserves and a percentage of the sum assured above the reserves; and,
    - ii. the Resilience Capital Requirement (“RCR”) a formulaic amount measuring how well matched the firm’s assets and liabilities are. (No RCR is required for a fund which is subject to a Peak 2 valuation.)
12. The ECR is the total of:
  - the LTICR;
  - the RCR; and,
  - the With-Profits Capital Component (“WPICC”).
13. The WPICC is discussed below. If the firm is not subject to Peak 2, the MCR equals the ECR Peak 2
14. Peak 2 applies to firms which had with-profits liabilities greater than £500 million at 31 December 2004 or firms with lower with-profits liabilities which opted to report under this regime.

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15. The aim of the realistic peak is to provide a realistic estimate of the with-profits liabilities of the firm. Stochastic models which produce a number of future scenarios based of different future economic, and other, factors are used to calculate the realistic estimates.
16. Peak 2 has two components:
- a. the realistic liabilities - liabilities calculated using realistic, rather than prudent, bases. The main constituents of the realistic liabilities are:
    - i. the with-profits benefit reserve (also known as the aggregate asset share, the accumulated premiums less costs plus investment returns for each individual policy);
    - ii. the future policy related liabilities of the fund which will include, amongst other things, the future costs of guarantees, future costs of financial options and the future cost of smoothing; and,
    - iii. the realistic current liabilities.
  - b. the Risk Capital Margin (RCM) - determined by running a series of prescribed stress tests relating to changes in market yields and credit spreads plus adverse changes to the future persistency of the business. The impact of management actions is allowed for in calculating the RCM. (The RCM replaces the need for a firm subject to Peak 2 to hold an RCR.)
17. The WPICC is calculated so as to ensure that the free capital on the regulatory peak is not larger than on the realistic peak, see the diagram above. The WPICC is intended to supplement the mathematical reserves to ensure that the firm holds adequate financial resources, in particular that adequate final bonuses can be paid.

#### **Pillar 2 – Individual Capital Assessment (ICA)**

18. The CRR is based on a formulaic approach to capital needs. In addition to this the FSA requires firms to assess the adequacy of their capital resources. The mechanism used for this is the ICA
19. All Firms must calculate an ICA. The philosophy of the ICA is for the firm to estimate on a realistic basis the level of capital it would need to ensure it had less than a 1 in 200 chance of its capital resources being inadequate over the next 12 months. Firms estimate the appropriate level of capital required through modelling and using stresses and scenarios to consider the major risk types, including:
- Credit risk – the risk of loss if another party fails to perform its obligations or fails to perform them in a timely fashion;
  - market risk – risks that arise from fluctuations in values of, or income from, assets or in interest or exchange rates;
  - liquidity risk – the risk that the firm might not have sufficient assets to meet its obligations both in timing and amount as they fall due;
  - operational risk – the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events;
  - insurance risk – risks arising from the nature of the insurance liabilities written; and,
  - other appropriate risks – for example risks associated with the firm's business development strategy.
20. The capital requirements for the individual risks are combined allowing for appropriate levels of non independence between the risks. As in the RCM, an assessment of the impact of appropriate future management actions can be included.
21. The FSA will use a firm's CRR as the benchmark when considering the appropriateness of its ICA and the adequacy of the firm's overall financial resources. The FSA will then set the level of capital it requires the firm to hold by issuing Individual Capital Guidance ("ICG"). If the ICG level of capital is breached the firm is required to submit a plan to the FSA showing how it will restore its capital resources to at least the ICG level. Normally the ICG will be at least equal to the greater of the CRR and ICA. The ICA and ICG are not public information.

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## APPENDIX 4 – SOLVENCY II

### Solvency II

1. The regulatory solvency reporting requirements for EU insurers and reinsurers are due to undergo a major overhaul with effect from the start of 2013, (but with the possibility that implementation may be delayed). This new regime is called Solvency II and aims to introduce solvency requirements that reflect the risks that insurers and reinsurers actually face and to introduce consistency across the European Union. UK companies will be required to adhere to a set of new, risk based capital requirements and, in contrast to the position under the current UK Pillar II requirements, the results will be shared with the public.
2. Solvency II will be a principles-based regime and will be based on three pillars:
  - a. Under Pillar I quantitative requirements define a market consistent framework for valuing the company's assets and liabilities.
  - b. Under Pillar II, insurers must meet minimum standards for their corporate governance, and also for their risk and capital management. There is a requirement for permanent internal audit and actuarial functions. Insurers must regularly complete an Own Risk and Solvency Assessment ("ORSA").
  - c. Under Pillar III, there are explicit requirements governing disclosures to supervisors and policyholders.
3. The Solvency Capital Requirement ("SCR") in Solvency II is the amount of capital required to ensure continued solvency over a 1 year time frame with a probability of 99.5%. The SCR is calculated based on the particular risks to which the insurer is exposed.
4. The Minimum Capital Requirement ("MCR"), which will be lower than the SCR, defines the point of intensive regulatory intervention. The MCR calculation is more formulaic and less risk sensitive than the SCR calculation. In order to allow companies, supervisors and the European Commission to consider the likely effects of the new regime on insurers and reinsurers, the industry has undertaken a number of trial runs, called "Qualitative Impact Studies" ("QIS") and produced results under the Solvency II rules as they have developed. The most recent of these, QIS 5, was completed in November 2010 and based on data as at 31 December 2009. The principles and rules set out in the technical specification for QIS 5 are, at the time of writing this report, the most up to date indication of the final form of Solvency II.

