

The following is a Summary of the Scheme Report dated 24 October 2011 prepared by the Independent Expert, John McKenzie, FFA.

## Introduction

1. I have been instructed by Standard Life Assurance Ltd (“SLAL”) and Standard Life Investment Funds Ltd (“SLIF”) to report as the Independent Expert on the terms of the scheme for the proposed transfer of the long term insurance business of SLIF to SLAL (the “Scheme”). I have also been instructed to review the effects of consequential amendments which will be required to the terms of the scheme by which The Standard Life Assurance Company (“SLAC”) demutualised in 2006 (the “2006 Scheme”).
2. Both SLAL and SLIF are subsidiaries of Standard Life plc (“SL”) which is listed on the London Stock Exchange. SL Group is used in this Summary to denote the wider group of companies owned by SL.
3. 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 will be presented to the Court of Session in Edinburgh.
4. My Scheme Report has been prepared in compliance with the relevant rules and guidance. It contains a description of the past operations of SLAL and SLIF, an outline of the terms and conditions of the Scheme and an assessment of the likely impact of the Scheme on SLAL and SLIF.
5. My assessment has considered the terms of the Scheme widely but has focused on:
  - The security of policyholder benefits; and,
  - The need to treat customers fairly and ensure policyholders’ reasonable benefit expectations are met, and, in particular, the effects on with-profits policyholders’ reasonable benefit expectations.
6. My terms of reference are set out in the Scheme Report and my assessment has been undertaken in the context of those terms. The Scheme Report, and this Summary of it, should be read in the context of the Scheme and not used for any other purpose. The Scheme Report takes precedence over this Summary.
7. I have relied on information provided to me by SLAL and SLIF. This Summary is subject to the same reliances and limitations as set out in the Scheme Report. Nothing in this Summary should be taken as investment advice or an endorsement of the products of SLAL or SLIF or of any other company in the SL Group or financial instruments issued by SL.

## Summary of Conclusions

8. 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.

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.

9. I also provided the following certificate in respect of the changes to the 2006 Scheme:
  - 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.

## Motivation for the Scheme

10. A new EU-wide regulatory regime is being developed for insurance business ("Solvency II") and is expected to come into force in 2013. The Scheme aims to streamline the operational structure for SLAL and SLIF and to create a more efficient capital structure under the new Solvency II regime.

## Background

### SL Group

11. SL Group is a multinational group of companies operating in a number of jurisdictions, including the UK, Germany, the Republic of Ireland, Canada, China and India. Its principal activities relate to the provision of long term insurance and investment products for the retail and wholesale markets. SLAL is the principal operating insurance company within the SL Group. SLIF is a shareholder owned subsidiary of SLAL.
12. SL Group sets general standards by which it expects its subsidiaries to be managed. These include a Risk Policy Framework which sets controls and standards for the acceptance and management of risks. SL Group also operates a Capital Management Policy which aims to hold capital at the highest level within its operating companies whilst having regard for the capital requirements of the local operating companies. In general, this policy requires each insurance fund to have adequate capital to meet its own needs and for further prudential capital to be held in the shareholder funds associated with the insurance fund. Thereafter capital would be held in companies at a higher level in the SL Group to ensure its availability to meet the overall capital demands of its businesses.

### SLAL

13. SLAL is authorised by the FSA to undertake long term insurance business in the UK. SLAL comprises of business which it has transacted directly or was transferred to it from SLAC under the terms of the 2006 Scheme, which has been written since 2006 or has been reinsured to it from other companies including SLIF and Standard Life Pension Funds Ltd ("SLPF"). As well as operating in the UK, it has branch operations in the Republic of Ireland, Germany (which includes Austrian business) and Canada. The Canadian business is wholly reinsured to SL's Canadian subsidiary company.
14. SLAL maintains a separate long term business fund ("LTBF"), which represents the assets and liabilities of its insurance contracts, and a shareholder fund ("SHF").
15. The structure and operation of SLAL's LTBF has been set largely by the requirements of the 2006 Scheme. The LTBF is split into a number of sub-funds, the principal of which are (for the purposes of reviewing the Scheme) the Heritage With-Profits Fund ("HWPF") and the Proprietary Business Fund ("PBF"). The other funds maintained within the LTBF are not subject to the arrangements which are to be altered by the Scheme as they have no direct relationship with SLIF.
16. The HWPF consists primarily of the business transferred from SLAC on demutualisation (although a small block of such business was allocated to the PBF). SLPF is a subsidiary of the HWPF. The PBF consists additionally of the bulk of the new business written since demutualisation.
17. The intention at the time of demutualisation was that the HWPF should be significantly de-risked by reinsuring certain risks to the shareholders. These arrangements were also intended to produce operational efficiencies by permitting the use of common internal funds for property-linked business.
18. The significant Reinsurance Arrangements for this purpose have the effect of
  - Transferring from the HWPF to SLIF the longevity risks related to its annuity business (to the extent that this is not already reinsured externally), and further, transferring from SLIF to the PBF, the risk that the longevity experience of this business may be much lighter than expected;
  - Reinsuring the investment element of the property-linked business of the HWPF to SLIF; and,
  - Reinsuring new business written in the PBF to SLIF on an original terms basis which has the same financial effect as if SLIF had written the business directly.

19. Since profits arising in SLIF and the PBF are attributable to SLAL's shareholders, it follows that in practice the longevity risk described above has a direct impact on SLAL but not on the HWPF directly. Similarly, the capital requirements related to new business are not materially different for SLAL's shareholders since they must fund this either in the PBF or provide capital to SLIF to do so.
20. SLAL benefits from floating charge arrangements (which are described further in 28 below) which apply to the assets in SLIF backing the liabilities reinsured to SLIF. The protection afforded by this arrangement accrues to SLAL generally and does not provide direct protection to SLAL's policyholders, so that in the event that SLAL was to be wound up after the charge on SLIF had crystallised, the assets charged would be generally available within SLAL and not be allocated to the specific line of business from which they arose.
21. The 2006 Scheme also created a mechanism to ensure that profits could be identified in the HWPF to become available (subject to certain constraints) for transfer to the account of the shareholders. This was achieved by defining the cash-flows on certain defined blocks of business in the HWPF. These "Recourse Cash Flows" ("RCF") are such that they identify the quantum of surplus arising each year and which may become available for shareholders if a number of tests related to the financial position of the HWPF are satisfied. The aim of the constraints is to ensure that there is an appropriate capital support mechanism in place in the HWPF and to prevent surplus being removed in the event that the HWPF as a whole was not in surplus.
22. The 2006 Scheme also anticipated that the RCF could be capitalised in such a way that the shareholder could secure the value of the cash flows whilst leaving the financial position of the HWPF intact. A contingent loan arrangement was introduced in 2009 between SLAL's SHF and the HWPF to achieve this effect in respect of a portion of the expected RCF.
23. The HWPF is managed in accordance with certain Core Principles which were set out in the 2006 Scheme and these form part of the wider Principles and Practices of Financial Management ("PPFM") by which the HWPF is managed. The PPFM will not be amended as a result of the Scheme. The Core Principles require, amongst other matters, that the HWPF be managed such that its bonus and investment policy should be set by reference to a "Notional Company" which was specified to have a capital structure similar to that of SLAC prior to demutualisation. SLAL does not actually have to maintain such a Notional Company but its capital requirements must be established having regard to the consequences of the application of this Core Principle.
24. Policy administration is outsourced to other companies in the SL Group. Investment management services are provided principally by a related company in the SL Group but also by a number of third party managers.

## **SLIF**

25. SLIF is authorised by the FSA to undertake long term insurance business in the UK.
26. SLIF also maintains an SHF and an LTBF, but it does not maintain separate sub-funds within the LTBF. All of the profits in SLIF accrue to its shareholder, SLAL's SHF.
27. SLIF has only ever transacted reinsurance business (i.e., accepted risks ceded from other insurance companies) and has never transacted business directly with the public. Consequently it has a very small policyholder base. Its policyholders include SLAL and SLPF. Policyholders also include 5 other insurance companies which are in-house insurance providers for external fund management companies ("EFM").
28. The bulk of the business which SLIF has accepted from SLAL, SLPF and the EFMs is property-linked although the precise nature of the reinsurance provided differs for each contract. SLIF's reinsurance of longevity risks from SLAL was described in 18 above. However, SLIF also reinsures other non-profit business from SLAL, in particular, annuity business written in SLAL's PBF since 2006. SLIF has created floating charge arrangements over its assets such that the assets backing property-linked and non-profit business can be separately identified and charged if a specified default event was to occur. The effect of this is to provide protection to policyholders in each class of business against risks arising in the other class of business. In practice, only SLAL benefits from the existence of the non-profit charge, but each of SLAL, SLPF and the EFMs benefits from the property-linked charge.
29. SLIF has retroceded certain risks to other insurance companies. This includes part of the longevity risk reinsured to the PBF (as noted in 18 above) and property-linked business to other insurance companies which include some of the EFMs. The external reinsurance of the property-linked business benefits

from floating charge arrangements on the assets of those companies similar to the arrangements maintained by SLIF. In the case of the EFMs, there is also a right of set-off.

30. Policy administration and investment management services are provided in the same way as for SLAL.

#### **Financial Condition of SLAL and SLIF prior to the implementation of the Scheme**

31. I considered the published solvency position as at 31 December 2010 for each of SLAL and SLIF (and updated information available as at 30 June 2011) and I concluded that they comfortably covered their capital requirements on a statutory basis. I noted that since SLAL owns SLIF, its published financial position is influenced by that of SLIF since SLAL's excess assets include an allowance for the net assets of SLIF after providing for its liabilities and capital requirements. Since SLIF does not transact with-profits business, the way in which it calculates its Capital Resources Requirement ("CRR") is different from that of SLAL. However, the asset cover provided for the CRR in each company was very similar at just over twice.
32. Since SLIF effectively bears the strains of transacting new business, although the new business is actually written in the PBF, SLAL must provide capital to SLIF to allow it to do so. A contingent loan has been provided by SLAL to SLIF such that, whilst SLIF does not need to provide (on a statutory basis) for the repayment of this loan, SLAL may not place any value on it (on the same basis).
33. I have also considered SLAL's internal risk-based assessment. This includes the assessment in respect of SLIF and the other subsidiaries of SLAL. As on the regulatory basis, SLAL's position is influenced by that of its subsidiaries. I also considered SLIF's standalone risk-based assessment. I concluded that the risk exposures of SLAL and SLIF in terms of the relative contributions made by each risk driver were similar. I particularly noted that SLAL had provided SLIF with an indemnity in respect of operational risk.

#### **Outline of the Scheme**

34. A summary of the Scheme is attached as Appendix 2 to the SLIF Policyholder Letter and is also displayed on SL's website, and is not repeated in this summary of the Scheme Report. I confirm that the summary of the Scheme set out therein is consistent with my understanding of the Scheme.

#### **Assessment of the Scheme**

##### ***Outline of SLAL's Structure after the Scheme has been implemented***

35. Once the Scheme has been implemented, SLAL will no longer have reinsurance relationships with SLIF but will reinsure some liabilities to other insurance companies (including those 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).
36. SLAL will receive reinsurance from SLPF and the EFMs. Floating charges will exist in SLAL in respect of property-linked business in favour of these reinsured parties.
37. SLAL's 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 externally rather than just the most extreme longevity 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.
38. 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, SLAL will not hold a capital requirement in respect of SLIF.
39. I considered the extent to which other companies of the SL Group are affected by the Scheme and 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.
40. The SL Group's management policies and standards and the governance arrangements which apply to SLAL and SLIF currently will continue to apply to SLAL after the implementation of the Scheme.

## ***Security of Benefits after the implementation of the Scheme***

### *Financial Position – Statutory Basis*

41. Since the financial position of each of SLAL and SLIF is satisfactory and no assets are being extracted from the companies under the terms of the Scheme, the overall financial position when the businesses are combined would also be satisfactory. In practice, if the Scheme had become effective at 31 December 2010, SLAL would have covered its revised capital requirements by almost two and half times. This represents a modest increase to the individual coverage for SLAL and for SLIF. The improvement in the cover provided arises largely due to the removal of double-counted capital requirements held in the companies separately.

### *Financial Position – Risk based assessment*

42. The risks borne by each of SLAL and SLIF are broadly similar. Since SLAL currently determines its risk-based capital requirements including those of its subsidiaries, SLAL's requirements on this basis will not be materially different after the Effective Date and may be expected to reduce slightly due to the removal of SLIF from the structure.

### *Effects of the fund structures*

43. I considered the separate company and fund structures currently in place and the effects of the Scheme in the amended structure. I concluded that the policyholders of SLIF would continue to have adequate protection since SLAL would provide a floating charge on its assets with equivalent effect to the charge which currently applies on SLIF's assets. I also considered the effects on SLAL's policyholders, and whilst they lose the protection currently afforded to SLAL by the current floating charges on SLIF, SLAL will hold the relevant assets directly. The security of SLAL's policyholders is not adversely affected by the floating charges which SLAL will grant in respect of the reinsured business from SLPF and the EFM's to be transferred by the Scheme as this relates only to their reinsured business's share of SLAL's property-linked assets.
44. The Scheme requires that certain reinsurance arrangements which the HWPF had with SLIF (and which were established under the 2006 Scheme) should be replicated by new arrangements with the PBF which will have the same effect as those they replace. The security provided by the new arrangements is not materially different from that provided under the current arrangements since in practice the risks lie with the same counterparties before and after the Effective Date.

### *Effects of Solvency II*

45. I also considered the potential effects of the new EU-wide regime to be introduced for insurance companies from 2013. Although it remains possible that there may be changes to the final specification of this new regime, SL Group has well established plans for its implementation to the entities within its remit. Calculations have been undertaken using the latest tested specifications and these suggest that SLAL would comfortably meet its new capital requirements. The new structure introduced by the Scheme should remove the uncertainty which still remains in the Solvency II specification arising from the treatment of intra-group reinsurance arrangements.
46. The Scheme provides protections in the event that any of the reinsurance arrangements to be transferred from SLIF to SLAL cannot be so transferred and have to be excluded. This is not expected to occur but the protections to be applied are appropriate and replicate the arrangements for the transferred policies.
47. **In my opinion, the security of the benefits of the Transferred Reinsurance Arrangements, the Excluded Reinsurance Arrangements and existing SLAL policies will not be materially affected by the implementation of the Scheme.**

### *Effects on Reasonable Benefit Expectations*

48. I considered whether the implementation of the Scheme was likely to change the benefit expectations of SLAL's policyholders or the holders of the reinsurance contracts issued by SLIF to be transferred under the Scheme.

### *Non-Profit and Property-linked Contracts*

49. The policies of the PBF are mainly non-profit or property-linked in nature for which the terms are largely fixed, or if variable are subject to limited discretionary powers to change them. Property-linked benefits are dependent upon the future investment performance of the internal linked funds in which they are invested. The Scheme does not alter the management of these funds and so there should be no change to benefit expectations.
50. The Scheme explicitly includes a clause allowing SLAL to close, merge or split internal linked funds if it is appropriate to do so in terms of efficient management and policyholder interest. This right currently exists and inclusion in the Scheme ensures that this right is maintained.

#### *With-Profits Contracts*

51. The arrangements introduced by the Scheme mirror the effects of the arrangements that currently apply to the HWPF. However, I considered whether the ability of SLAL to satisfy the requirements of the 2006 Scheme regarding the "Notional Company" would be affected under the new structure on the implementation of the Scheme. I concluded that since SLAL's SHF was the prime source of capital for SLAL's and SLIF's businesses currently, the ability would not be materially changed by the implementation of the Scheme. I also noted that profits arising in the HWPF which would accrue to SLAL's shareholder could be available for this purpose. I concluded that the implementation of the Scheme was unlikely to impact upon this requirement of the 2006 Scheme.
52. The fixed interest assets in the HWPF are currently used as the assets to be posted as collateral for any derivative transactions in SLAL whether related to the HWPF or the PBF. In SLIF, a similar arrangement applies through the use of one of its fixed interest funds. On implementation of the Scheme, the HWPF will fulfil the role for SLAL including the transferred business. In very extreme conditions, these arrangements could have an effect on the HWPF since assets may not be available to it. Since the risk is very small and since SLAL has implemented procedures to monitor usage and to take corrective action, if appropriate, I consider this to be incidental to the implementation of the Scheme and would not unfairly affect policyholders' interests.
53. I also considered the effects of the Scheme on the benefits arising from other with profits funds maintained by SLAL. These funds are intended to be managed within their own resources without reliance on other funds in SLAL. The terms of the Scheme do not directly impact upon these funds. I concluded that there was unlikely to be any change to the benefit expectations in respect of such policies.

#### *The Floating Charges*

54. In the event of the floating charges being triggered in SLAL after the Effective Date, I noted that it could be possible that if SLAL was then wound up, the proportion of the liabilities reinsured from SLPF and the EFMs protected by virtue of the floating charges could be greater than the proportion applicable to SLAL's direct policyholders. I considered this to be an immaterial risk having regard to the fact that SLAL was well capitalised, that SLAL getting into difficulties was unlikely to be due to the reinsured business and that the proportion applicable to the direct policyholders would be broadly the same as would have applied in those circumstances in the absence of these reinsurance agreements. I concluded that the floating charges to be granted by SLAL on the implementation of the Scheme were unlikely to have a materially adverse effect on the benefit expectations of SLAL's policyholders.
55. **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 Matters*

##### *Changes to the 2006 Scheme*

56. As a consequence of the new structure created by the Scheme, certain of the reinsurance arrangements referred to in the 2006 Scheme will terminate. The reason for the termination is by the operation of law rather than by the application of the terms of the reinsurance agreements, which is the condition anticipated by the 2006 Scheme. The first amendment to the 2006 Scheme clarifies that the intended consequences of the 2006 Scheme should still apply and to ensure that the relative interests of the HWPF and of SLAL's shareholders are protected.
57. The second amendment reflects the effects of reinsurance on the calculation of the RCF in the HWPF. The new arrangements to be introduced between the PBF and the HWPF have the effect of

reinsurance but legally are not. The 2006 Scheme also only anticipated that intra-group reinsurance would only ever be to SLIF, and extra flexibility in the management of the HWPF will be provided if the scope is extended to include any intra-group reinsurance in respect of the defined blocks of business in the HWPF.

58. The proposed changes 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 to them.

#### *Tax*

59. It is not expected that there will be any material adverse tax consequences as a result of implementing the Scheme.

#### *Service Standards, Administration and Expenses*

60. The policy administration and investment management arrangements in respect of the SLAL's and SLIF's business are currently integrated through the common provision of services. There is no expectation that service quality should alter as a result of the implementation of the Scheme.
61. The implementation of the Scheme is unlikely to cause an increase to the expenses of administering business. The costs of implementing the Scheme will be met from the PBF and will not be passed on to policyholders.

#### *Communications with Policyholders*

62. I considered the communications which SLAL and SLIF proposed to send to policyholders. SLAL has applied to the Court for a waiver from the requirement to send individual notification to each of its policyholders. I concluded that this was reasonable in the circumstances of this Scheme since there would be no material change to the security of benefits, the risks to which SLAL's policyholders would be exposed and to their benefit expectations. I considered the alternative arrangements being proposed to be reasonable.

#### *Consequences of the Scheme not proceeding*

63. If the Scheme does not proceed, the current arrangements will stay in place and there will no change to the operational arrangements but the expected capital efficiencies may not be achieved.