Explanatory Note

Special Resolution, Special General Meeting 29 April 2015

1. Background

1.1. 'Mergers and Acquisitions' is one of the three core strands to Scottish Friendly's strategy for growth. It includes 'transfers of engagement' and the aim is to gain additional economies of scale, plus a diversified income stream that is independent of the stock market through administration charges to the transferring policyholders.

1.2. Since 2006 we have transferred in Rational Shelley Friendly Society Limited, Preston Operative Friendly Society, a small book of business from Pioneer Friendly Society Limited, London Aberdeen & Northern Mutual Assurance Society (LANMAS), Royal Standard Friendly Society Limited and, most significantly, Scottish Legal Life Assurance Society Limited. Collectively these six transactions have added over £230m funds under management and generate significant administration income per annum to Scottish Friendly policyholders.

1.3. The proposed transfer from Marine and General Mutual Life Assurance Society (M&GM) is a particularly significant opportunity in line with Scottish Friendly's overall strategy.

1.4. The key aspects of the opportunity for Scottish Friendly are:

(i) scale – the transfer from M&GM would involve approximately £1.1bn[1] of admissible assets; that scale is clearly very significant for Scottish Friendly although at the same time M&GM has a relatively small number of policies, as discussed below;

(ii) policy count – the M&GM business that would transfer is made up of approximately 76,000[1] policies; policy count is one of the key factors of complexity in transferring business and integrating policy administration. To put the policy count into perspective, for the Scottish Legal Life transaction, we transferred over 500,000 policies so we anticipate that 76,000 will be relatively straight forward;

(iii) similarity to Scottish Friendly – Scottish Friendly has experience in both transferring in and administering the majority of product types within the M&GM business; while M&GM does have some annuity products that we have not transferred before, we do have experience in each of the component parts, as outlined at 5.3 below;

(iv) shared IT platform – M&GM uses the Talisman system (as does Scottish Friendly) for the vast majority of its policy administration; that means Scottish Friendly can 'lift and shift' M&GM's implementation of Talisman and run that system alongside Scottish Friendly's from day one, immediately realising synergies for all policyholders;

(v) experience – as anticipated at the time of the LANMAS transfer, Scottish Friendly can draw synergies from its experience of an insurance company

[1] Figures as at 31 December 2013

transfer (LANMAS) to this transaction, where the legal process is distinct from that for transferring other friendly societies; and

(vi) revenue - the proposed transfer will provide an additional revenue stream to Scottish Friendly policyholders over the life time of the M&GM policies.

1.5. We believe these benefits can be achieved within acceptable risk parameters for Scottish Friendly given the ring fenced structure, the reinsurance arrangements in place, the similarity with Scottish Friendly's own business, the shared IT platform, Scottish Friendly's prior experience of transfers and Scottish Friendly's established efficiencies which enable us to take the business on with only a small increase in headcount and infrastructure; each of these aspects is discussed further below.

2. M&GM

2.1. M&GM is a mutual insurance company set up in 1852; it is the oldest existing registered company in the UK. In light of the success in recent years of its enhanced annuity business, M&GM needed to raise additional capital to support sales of those products. Following the approval of M&GM members, this was achieved in December 2013 by setting up a new company privately funded by venture capital, MGM Advantage Life Limited, and reinsuring the enhanced annuity business to MGM Advantage Life ahead of a transfer; the transfer of that enhanced annuity business was subsequently completed in October 2014. In December 2013, M&GM closed to new business, entering into run-off, and the administration of all M&GM business was outsourced to a sister company of MGM Advantage Life (under the parent company, MGM Advantage Holdings).

2.2. The M&GM Board then decided to seek a transfer of its business in order to increase the security of policyholders' benefits, reduce overall costs and risks, and enhance the benefit prospects for with-profits policyholders.

2.3. M&GM's transferring business has 76,000 policyholders, of whom 20,000 are members and £1.1bn of admissible assets at 31 December 2013.

2.4. M&GM's capital position is not as strong as that of Scottish Friendly. However, the free assets attributable to the M&GM with-profits business will immediately increase on transfer. There are two reasons for this: (i) it will no longer be necessary to carry the reserves that M&GM is required to set aside whilst operating on a stand-alone basis; and (ii) the significantly reduced expenses arising from Scottish Friendly's administration efficiency will be reflected. The release of reserves and other synergies are such that Scottish Friendly's capital cover ratio will not be significantly diluted post transfer, with a combined ratio projected as shown in the table below. The terms of the proposed transfer allow for a capital support mechanism to provide additional short-term capital to the M&GM sub fund from Scottish Friendly's main fund if required. The dilution of Scottish Friendly's capital position is judged to be an appropriate investment for the level of benefits that will accrue to Scottish Friendly's members over the life time of the M&GM policies.

SF Pillar 1 result (£m)[1]	Pre transfer	Post transfer
Total Assets	894.8	1,662.7
Total Liabilities	725.2	1,403.1
Capital resources	169.6	259.5
Capital resources available[2]	168.4	258.5
Capital resources requirement	91.1	170.8
Excess capital resources	77.3	87.6
Capital cover	185%	151%
[1]figures based on end-2013 results, adjusted for effect of transfer		
[2] This represents the total capital resources less a deduction in respect of regulated subsidiaries and the difference between the realistic and statutory value of assets (i.e. the mid/bid spread).		

2.5. Further discussion of the comparative financial positions is included in the report of the Independent Expert (summary attached).

3. Corporate Governance

3.1. Having decided that it was appropriate to seek a potential transfer (as outlined at 2. above), the Board of M&GM carried out a rigorous process to find suitable partners. Criteria which they considered included the security of policyholder benefits, the potential benefits payable on with-profits policies, the culture of the potential partner, and the costs and risks involved in implementing the proposal, including the experience of the potential partner. A number of different organisations were contacted initially; after a series of proposals and presentations, the Board of M&GM unanimously concluded that Scottish Friendly's proposal was the most attractive for its policyholders. In addition to substantial savings in future expenses, the Board of M&GM has reported to its policyholders that "Scottish Friendly has a strong focus on customer service" and, based on its due diligence, the M&GM Board is "confident that our policyholders will receive excellent administration and customer support from Scottish Friendly". The M&GM Board also reported that Scottish Friendly has "an excellent track record in carrying out transactions of this kind".

3.2. Scottish Friendly conducted due diligence procedures over the period of the M&GM selection process; throughout, Scottish Friendly was supported by EY with additional scrutiny from Scottish Friendly's independent With Profits Actuary; legal advice was provided by CMS Cameron McKenna (incorporating the former Dundas & Wilson).

3.3. As M&GM is an insurance company, the legislation governing transfers as it relates to Friendly Societies, such as Scottish Friendly, requires the approval of the Delegates on behalf of members. And given the scale of this transaction, this is a matter that the Board would certainly bring to the Delegates irrespective of the prevailing legislation. Delegates' approval is sought by way of the special resolution, as per the Notice. M&GM is required to make a change to its Articles, to provide for Scottish Friendly becoming the sole member of M&GM so ensuring that there is an orderly wind-up of that company, and so will be seeking members' approval for that change, which is a component part of the transfer.

4. Process

4.1. The proposed transfer is to be carried out under section 111(1) of the Financial Services and Markets Act 2000. Scottish Friendly and M&GM have followed a strict legal and regulatory process that includes consulting with our regulators, the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA') (together the 'Regulators'), and obtaining an assessment of the transfer from an Independent Expert. The duty of the Independent Expert is to review the impact of the changes resulting from the transfer against the interests of all affected policyholders (including the Scottish Friendly policyholders) and to write a report on his findings to the Court. That report is also provided to the Regulators. A summary of the Independent Expert's report is attached, having been duly approved as providing the key points of the proposal.

4.2. Reports have also been prepared by the respective Actuarial Function Holders and With-Profits Actuaries of Scottish Friendly and M&GM.

4.3. The terms of the transfer are detailed in documentation ('the Scheme'). Copies of the full Scheme document are available on request from the Secretary, David Elston and on the Scottish Friendly website www.scottishfriendly.co.uk.

4.4. The transfer requires an order given by the High Court of Justice of England and Wales (the 'Court') sanctioning the Scheme. The proposed effective date of this transfer is [1 June 2015].

4.5. In addition to the approvals which are being sought as described in paragraph 4.1 above, legislation requires both Scottish Friendly and M&GM to notify its respective policyholders of the proposed transfer and invite them to make representations (if any) to the Court. Scottish Friendly has been granted a waiver from the Court from the requirement to notify its policyholders on the basis that the approval process from the delegates, coupled with the extensive advertisement of the transfer which Scottish Friendly and M&GM are undertaking, are sufficient.

5. Key Features of the Terms of the Transfer

5.1. Scottish Friendly will purchase the unit linked and non-profit business of M&GM for £10,000,000 payable on transfer; those policies will transfer into the Scottish Friendly main fund.

5.2. The M&GM with-profits business will transfer across into a closed ring-fenced sub fund of the long term business fund of Scottish Friendly ('the M&GM sub fund'). This means that those assets and liabilities are maintained separately for transferred legacy M&GM with-profits business. It is expected that the sub-fund will run-off smoothly over time and the terms of the Scheme allow for the cessation of the sub-fund at an appropriate time in future when it has largely run-off. If either the M&GM sub fund or Scottish Friendly became insolvent, the ring fence would collapse and Scottish Friendly/M&GM members would collectively become liable for outstanding liabilities. Both insolvency scenarios are considered extremely remote (less than a one in two hundred year event);

although, if considered as a standalone fund, the M&GM sub fund is not as strong as Scottish Friendly overall, it is solvent, will be managed appropriately in accordance with its level of free assets, and thorough due diligence has been carried out.

5.3. The annuity business that has not been transferred to MGM Advantage Life will transfer to the M&GM sub fund within Scottish Friendly. The key features of these products are already in place within Scottish Friendly, such as links to externally managed unit linked funds, bonuses and options for income draw down. The one annuity product that is not currently administered by or on behalf of M&GM on Talisman (namely the Flexible Income Annuity, ('FIA')) will be migrated to Talisman on transfer; it has approximately 8,000 policies - a very small migration compared to previous transactions we have completed. The unit holdings of the FIA business are already reinsured with MGM Advantage Life, and the other annuity business is expected to be fully reinsured prior to the transfer.

5.4. The M&GM sub fund will have its own statement of Principles and Practices of Financial Management (PPFM). The new PPFM has been based on the current M&GM PPFM and has been duly agreed between the parties, and reviewed by the Independent Expert.

5.5. A M&GM sub fund Monitoring Committee, similar in nature to that for the Scottish Legal Life policies, will be established on transfer, which will be in place for at least three years unless all members of that Monitoring Committee agree to dissolve the Committee earlier. On transfer, Scottish Friendly will appoint three members to the Committee, M&GM two.

5.6. The M&GM staff pension fund will transfer across, and financial responsibility will be within the M&GM sub fund. The pension scheme will be fully funded on the statutory basis on the date of transfer, with the stated intention in the Scheme of buying out the liabilities in due course from the funds of the M&GM sub fund.

5.7. All M&GM policyholders will become members of Scottish Friendly, including those M&GM policyholders not currently members of M&GM. M&GM members post-transfer will have the same rights in future as Scottish Friendly members.

5.8. Scottish Friendly will receive an administration charge payable from the M&GM sub fund. This is based on a per policy charge, depending on the product type. Efficiencies at Scottish Friendly combined with the removal of overheads (such as M&GM no longer needing its own actuarial function or board) mean that all policyholders benefit – Scottish Friendly will earn a margin on the amounts charged to transferred M&GM policyholders and at the same time M&GM policyholders will be subject to lower costs than at the moment to administer their policies.

5.9. The M&GM sub fund will also pay Scottish Friendly an investment management charge. This charge is payable at a fixed % of the funds under management across all asset classes and all investment vehicles (calculated on the average funds each quarter).

5.10. There is provision in the Scheme for M&GM policyholders to be charged exceptional costs, where such costs are only attributable to M&GM business, subject to a de-minimis amount per expense and subject to review by the sub fund Monitoring Committee and the Scottish Friendly With Profits Actuary.

5.11. As for all previous transfers to Scottish Friendly, the administration of all M&GM policies will be fully integrated with existing Scottish Friendly business, and will benefit from the same service levels; there is no distinction made within Scottish Friendly for 'legacy business'.

6. Concluding Remarks

6.1. The Scottish Friendly Board has considered the strategic, prudential, operational and conduct risks of this transaction in detail, with risk registers assessing the risks of both the transaction and the implementation.

6.2. As noted above, the transaction is in line with the agreed strategy; the Board is satisfied that it does not compromise any other strategic initiatives. Prudential risks, in particular with regard to the capital position of the combined entities post transfer, have been reviewed in detail under a number of scenarios, with assistance from EY, and have been considered by the independent With Profits Actuary. Operational risks include the take on of the administration and any impact on 'business as usual' and on ongoing projects, such as reporting under the new financial reporting and Solvency II regimes in due course. Conduct risks include consideration of the impact of the transfer on all sets of policyholders; the Board judges the transfer to be beneficial to all parties. In addition risk registers across the functions of the business have been updated to reflect ongoing implementation. In each case the Board is satisfied that the risks are judged to be within Scottish Friendly's agreed risk appetite, with plans for due mitigation.

Please feel free to contact me or Jim Galbraith, either directly or via David Elston as Secretary, if you wish to raise any questions in advance of the meeting. Otherwise there shall of course be an open discussion and an opportunity for questions in the course of the meeting.

The Board very much hopes that the resolution will meet with your approval in what it judges to be a very valuable opportunity for Scottish Friendly, in the best interests of members.

Fiona McBain
Chief Executive
26 March 2015

Attachments

1. M&GM Policyholders Circular including Summary Report of Independent Expert