

**REPORT OF THE INDEPENDENT EXPERT
ON THE PROPOSED TRANSFER OF THE
LONG-TERM BUSINESS OF MARINE AND
GENERAL MUTUAL LIFE ASSURANCE
SOCIETY TO SCOTTISH FRIENDLY
ASSURANCE SOCIETY LIMITED**

22nd January 2015

Prepared by:



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1. Introduction

1.1. Introduction

I have been jointly appointed by Marine and General Mutual Life Assurance Society (“M&G”) and Scottish Friendly Assurance Society Limited (“SF”) to act as the Independent Expert in relation to the proposed transfer of the long-term business of M&G to SF (the “Transfer”) under section 109 of Part VII of the Financial Services and Markets Act 2000 (“FSMA”). The purpose of this report (the “Report”) is to set out the results of my review of the terms of the Transfer.

I am a Fellow of the Institute of Actuaries and hold a Life Actuary (including with-profits) Certificate issued by the Institute and Faculty of Actuaries. I am a Partner in Oliver Wyman Limited’s European Insurance Practice and the head of the actuarial practice in the UK. Since joining Oliver Wyman in 1995, I have built up expertise in a wide area of insurance company strategic advice and risk management. I have been involved with the mutual sector since starting work over twenty five years ago and have performed a regulatory role as Appointed Actuary, Actuarial Function Holder or With-Profits Actuary within the mutual sector since 1996. In 2012, I performed the role of Independent Actuary in relation to the transfer of long-term insurance business of Tunbridge Wells Equitable Friendly Society to Forester Life Limited under Part VIII of the Friendly Societies Act 1992.

I do not hold any insurance policies or have any other financial interest in M&G or SF (or any of their subsidiaries). In addition, I have not previously provided advice to either M&G or SF (or any of their subsidiaries) in any capacity. Furthermore, I have consulted my colleagues and believe that Oliver Wyman Limited has not previously advised M&G or SF (or any of their subsidiaries).

The Prudential Regulation Authority (“PRA”), having consulted the Financial Conduct Authority (“FCA”), has considered the skills needed to make a proper Report and approved my appointment as Independent Expert.

The cost of my work is to be jointly and equally paid for by both M&G and SF.

1.2. Regulatory and professional guidance

I have produced this report in accordance with the guidance set out in chapter 18 of the Supervision manual (“SUP”) of the Regulatory Handbook. Relevant sections of the guidance, with reference to where I have considered each one in the Report if relevant, are set out in Appendix A.

I have produced this report in accordance with the following Technical Actuarial Standards (TAS) issued by the Financial Reporting Council’s Board for Actuarial

Standards: Insurance TAS, Transformations TAS, TAS D (Data) and TAS R (Reporting Actuarial Information).

1.3. Terms of reference

Full details of my terms of reference, which have been discussed and agreed with M&G and SF, are set out in Appendix B. The terms have been reviewed and approved by the PRA.

In forming my views, I have taken into account all matters that I consider to be relevant and material in assessing the impact of the Transfer. In the context of this report, where I refer to a “material” issue in relation to the security of policyholder benefits, I define this as an issue where the Transfer results in a risk of more than 0.5% per annum that the security of policyholder benefits will be compromised.

I have considered the impact of the Transfer against the likely position of M&G and SF if the Transfer is not completed. With respect to M&G, I have adopted as my primary reference point for the likely position (if the Transfer is not completed) the pro-forma balance sheet position of M&G under the various solvency bases as set out in a document provided to M&G’s Board on 16th September 2014, with due regard for the M&G Board’s stated strategy to actively investigate opportunities to transfer its business into other insurance companies and friendly societies. However, I have not considered any other possible alternative arrangements to the Transfer.

The Report assesses the likely impact of the Transfer on the existing policyholders of M&G and SF. It does not consider the impact of the Transfer on any new policies written into SF following the Transfer.

In addition to the areas of investigation listed in Appendix B, I have also considered the Transfer from the point of view of potential “conduct risk” with respect to M&G and SF policyholders. This is set out section 7 of the report.

1.4. Peer Review

This report has been reviewed by Neil Reynolds who is a Principal from Oliver Wyman Limited’s actuarial practice in the UK with similar experience and standing to me, and he agrees with my conclusions as set out in this report.

1.5. Information requested and data used

In producing the Report I have relied on information provided by M&G, SF and their respective professional advisers without independent verification of the accuracy or

completeness of information provided. However, wherever possible, I have reviewed the information for reasonableness and consistency and against my understanding of generally accepted market practice.

Furthermore, I have relied on the judgement and conclusions reached by the Actuarial Function Holders and With-Profits Actuaries for the respective funds in M&G and SF, as documented in the Actuarial Function Holder and With-Profits Actuary reports produced in connection with the Transfer.

I consider that it is reasonable for me to rely on the information and judgements described in this section as they are provided by parties acting in the interest of their respective members and policyholders and in accordance with the regulations and guidelines set out by:

- The PRA and FCA
- The Institute and Faculty of Actuaries
- The Financial Reporting Council

Details of the information that I have been provided with are set out in Appendix C.

2. Executive summary and conclusions

2.1. Context

I have been jointly appointed by M&G and SF to act as the Independent Expert in relation to the proposed transfer of the long-term business of M&G to SF (the “Transfer”) under section 109 of Part VII of the Financial Services and Markets Act 2000.

In forming my views, I have taken into account all matters that I consider to be relevant and material in assessing the impact of the Transfer. I have considered the following factors:

- Terms of the transfer
- Reinsurance arrangements
- Financial position of M&G and SF pre and post Transfer
- Financial effect of the Transfer on M&G and SF policyholders in relation to:
 - Security of benefits
 - Investment strategy
 - Expense and charges
 - Benefit expectations and bonus prospects
 - Risk profile and capital management policy
- Administration and governance
- Membership rights and policyholder communications
- Tax

I have considered the impact of the Transfer against the likely position of M&G and SF if the Transfer is not completed. With respect to M&G, I have adopted as my primary reference point for the likely position (if the Transfer is not completed) the pro-forma balance sheet position of M&G under the various solvency bases as set out in a document provided to M&G’s Board on 16th September 2014, with due regard for the M&G Board’s stated strategy to actively investigate opportunities to transfer its business into other insurance companies and friendly societies. However, I have not considered any other possible alternative arrangements to the Transfer.

The Report assesses the likely impact of the Transfer on the existing policyholders of M&G and SF. It does not consider the impact of the Transfer on any new policies written into SF following the Transfer.

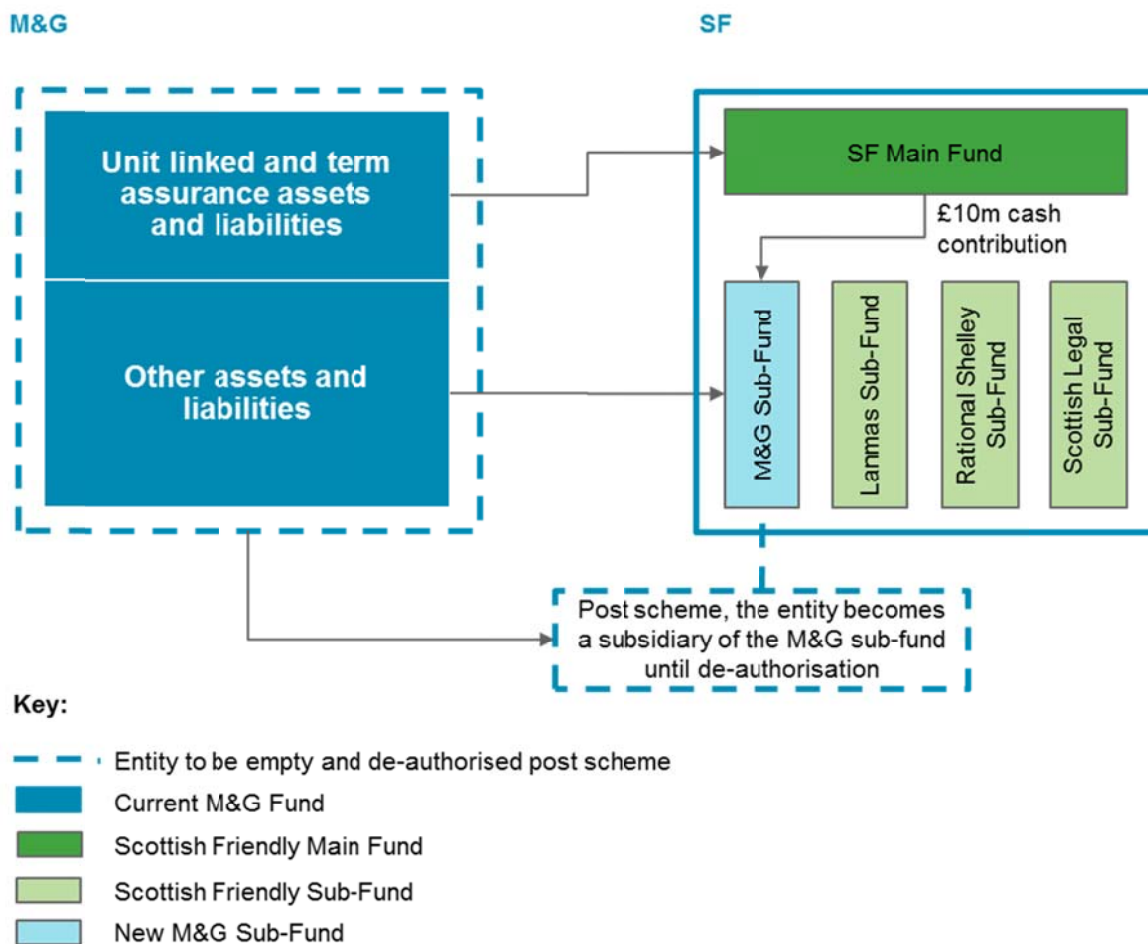
I have produced this report in accordance with the guidance set out in chapter 18 of the Supervision manual (“SUP”) of the Regulatory Handbook.

2.2. Terms of the Transfer

The key terms of the Transfer are set out below:

- All assets and the business of M&G (excluding unit-linked and term assurance business) will be transferred to a newly established fund (the “M&G Sub-Fund”) within SF, which will operate as a closed with-profits fund, ring-fenced from the other funds of SF
- The assets and liabilities of the unit-linked and term assurance business will be transferred to the SF Main Fund. The amount of assets transferred will be based on defined components of liability for the transferring business, as published in the annual returns submitted to the PRA (“PRA Returns”) as at 31st December 2014, adjusted for the period from that date until the Effective Date.
- The SF Main Fund will pay £10m into the M&G Sub-Fund
- SF will charge the M&G Sub-Fund fixed per policy annual administration fees in respect of the transferring policies (the level of charges depends on the type of policies). The per policy fees will apply for the entire duration of the policy and increase annually in line with the Average Weekly Earnings Index published by the Office of National Statistics.
- SF will also charge the M&G Sub-Fund an annual investment management charge of 0.2% per annum with respect to assets invested in the M&G Sub-Fund (excluding assets backing the FIA unit funds)
- SF will assume the role of statutory employer with respect to the Staff Pension Plan. However, the cost of funding the Staff Pension Plan will be fully allocated to the M&G Sub-Fund.
- SF will provide capital support to the M&G Sub-Fund in the event of a capital shortfall. The charge for this capital support to the M&G Sub-Fund will be 4% per annum for any amount under £10m and 6% per annum for any amount over £10m, above the base rate of Barclays Bank plc.
- The Transfer is conditional on M&G having at least a specified minimum level of solvency capital on a Pillar 2 basis at the Effective Date
- A Monitoring Committee will be established to provide independent oversight of the M&G Sub-Fund and oversee its integration. The committee will be made up of five members, three of which will be nominated by SF and two by M&G.
- All M&G policyholders will become members of SF

An illustrative diagram of the Transfer is shown below:



Note: M&G has a subsidiary, MGM Assurance (Trustees) Limited (not shown in the diagram), which will become a subsidiary of SF; it has an issued share capital of £1,000 and a de-minimis value which would be attributed to the M&G Sub-Fund. I do not consider the subsidiary to be relevant or material to assessing the impact of the Transfer.

Under the terms of the Transfer, the current members of M&G will give up their membership and voting rights in M&G at the Effective Date. Immediately after that, SF will be granted sole membership of M&G and become responsible for the governance and administration of M&G while it continues in existence until it can be formally dissolved.

Both managements and Boards of SF and M&G are supportive of the Transfer and believe that the Transfer will have a positive impact on their respective members and policyholders.

2.3. Financial position pre and post Transfer

I have considered the financial impact of the Transfer under three separate solvency bases: two of these (Pillar 1 and Pillar 2) are currently in force while the third (Solvency 2) is expected to come into effect in the near future.

In relation to the Pillar 1 financial impact:

- The overall size of SF would grow significantly, with total assets (net of existing reinsurance arrangements) doubling from £0.8bn to £1.6bn
- The financial position of SF's existing sub-funds are unchanged due to the ring-fenced nature of the funds
- The SF Main Fund would grow in size as a result of the transfer of unit-linked and term assurance business from M&G. Its solvency would be strengthened, with Free Assets increasing under both Peak 1 and Peak 2. This is mainly because of the expense margins it expects to make in administering the M&G policies as a result of the Transfer.
- The Peak 1 Free Assets for M&G (the Sub-Fund after the Transfer) improves significantly following the Transfer, driven by the combination of significant cost savings arising from the Transfer and the £10m contribution from SF.
- The level of Peak 2 "planned enhancements" for the M&G Sub-Fund is lower compared to the position at 31 December 2013. However, this largely reflects events prior to the Transfer, including the £9m distribution to members and the reinsurance of the Standard and Select annuities (which reduced liabilities by roughly a third). When viewed in isolation, the Transfer results in an increase in Peak 2 Free assets of £19m.

In relation to the Pillar 2 financial impact:

- M&G provided a detailed analysis of the impact of the Transfer on its ICA position as at 31st December 2013. I have reviewed the underlying methodology and assumptions behind the analysis and consider them to be reasonable.
- An insurer's Pillar 2 capital position is not publicly disclosed and contains commercially sensitive information. Due to this commercial sensitivity I have avoided quoting the full detailed results of M&G's analysis in my report. However, the results indicate that the Transfer would be beneficial to the policyholders of M&G in terms of the Pillar 2 financial position. The analysis also showed that the M&G Sub-Fund would retain a healthy level of Pillar 2 Free Assets after the Transfer.
- SF performs a separate ICA calculation for the SF Main Fund and each of the sub-funds. The SF Main Fund's Pillar 2 position will improve as a result of the expected expense savings following the Transfer. Due to their ring-fenced nature, the Pillar 2 position of the sub-funds will not be affected by the Transfer.

In relation to the Solvency 2 financial impact:

- I have received from both SF and M&G their submissions to the PRA which show their respective financial positions as at 31st December 2013 under the draft technical rules underpinning the latest data collection exercise undertaken by the PRA in August 2014. I have further received additional analyses from SF covering the estimated post Transfer combined financial position as at 31st December 2013.
- These analyses show that SF and M&G both expect the Transfer to significantly improve the financial position under Solvency 2. Furthermore, the information provided suggests that SF expects each of the respective sub-funds (including the M&G Sub-Fund and SF Main Fund) to be able to comfortably cover the capital requirements of Solvency 2 (defined as the “Solvency Capital Requirement” under Solvency 2).
- In the event that the M&G Sub-Fund is at risk of being unable to cover its Solvency Capital Requirements, further management actions could be taken to preserve the solvency of the M&G Sub-Fund. For example, the Solvency Capital Requirement would be lower if planned management actions are in place in the event of adverse scenarios occurring which would threaten solvency. In the event that the M&G Sub-Fund is unable to cover its Solvency Capital Requirements, SF is committed under the terms of the Transfer to provide capital support to the M&G Sub-Fund.
- It must however be noted that the rules applicable under Solvency 2 remain in draft form and could be subject to changes. The above therefore cannot be relied upon for the actual financial position for the combined entity when Solvency 2 comes into force. However, I do not expect any major changes in the proposed Solvency 2 rules which would jeopardise the solvency position of SF or the M&G Sub-Fund after the Transfer.
- I shall continue to monitor the developments in Solvency 2 and assess their implications for the Transfer, and will provide an update (and, where appropriate, the effect of any significant developments on the Transfer) in a supplementary report if necessary.

2.4. Financial effect of the Transfer on M&G policyholders

I have assessed the impact of the Transfer on all groups of policyholders in terms of security of benefits. Based on the relevant factors as described in the Report, in my opinion the security of benefits for all M&G policyholders will be significantly enhanced by the Transfer.

The level of premiums payable for all policies will not be affected by the Transfer. Due to the contractual nature of non-profit business, the benefits of non-profit policies will not be affected by the Transfer.

I have also assessed how the Transfer would affect the investment strategy and expense charges with respect to with-profits (including FIA) and unit-linked policyholders. Based on the relevant factors as described in the Report, in my opinion the with-profits policyholders in the M&G Sub-Fund and the transferring unit-linked and FIA policyholders will not be adversely affected by the Transfer in relation to investment strategy.

Furthermore, the with-profits policyholders in the M&G Sub-Fund will benefit from significant expense savings as a result of the Transfer and it is SF's intention that the benefits of the cost savings will be distributed to eligible policyholders in the M&G Sub-Fund fairly over time once the financial condition of the fund permits such distributions. Unit-linked policyholders will not be adversely affected by the Transfer in relation to expenses and charges.

In addition, I have considered the implications of the Transfer for the benefit expectations and bonus prospects for with-profits policyholders. Taking into account the considerations set out in the Report, in my opinion with-profits policyholders in the M&G Sub-Fund will not be adversely affected by the Transfer with respect to benefit expectations and bonus prospects.

Finally, I have evaluated the effect of the Transfer on the risk profile and capital management of the M&G business. It is my opinion that the Transfer will have a positive impact on the risk profile of M&G (and the M&G Sub-Fund after the Transfer). With the exception of the provision of capital support by the SF Main Fund and the possible additional distribution of the estate in the future, there are no planned changes to the capital management policy of the M&G business as a result of the transfer.

2.5. Financial effect of the Transfer on SF policyholders

I have assessed the impact of the Transfer on all groups of policyholders in terms of security of benefits. Taking into account the considerations set out in the Report, in my opinion the Transfer will not have an adverse effect on the security of benefits of current SF policyholders in the SF Main Fund or any of the sub-funds.

The level of premiums payable for all policies will not be affected by the Transfer. Due to the contractual nature of non-profit business, the benefits of non-profit policies will not be affected by the Transfer.

I have also assessed how the Transfer would affect the investment strategy and expense charges with respect to current SF with-profits, unit-linked and non-profit

policyholders. Taking into account the considerations as set out in the Report, in my opinion the Transfer is unlikely to have a material impact on expense charges for with-profits policyholders in the SF Main Fund relative to the scenario in absence of the Transfer. Furthermore, the Transfer will not result in any changes to the investment strategy of assets invested on behalf of the current SF with-profits, unit-linked and non-profit policyholders.

Moreover, I have evaluated the effect of the Transfer on the benefit expectations and bonus prospects of current SF with-profits policyholders. Taking into account the considerations as set out in the Report, in my opinion the Transfer will not have an adverse effect on the benefits expectations and bonus prospects of current SF with-profits policyholders.

Lastly, I have considered the effect of the Transfer on SF's risk profile and capital management. Taking into account the considerations set out in the Report, in my opinion the Transfer will not have an adverse effect on the risk profile or capital management policy in the SF Main Fund or any of the sub-funds.

2.6. Administration and governance

In the Report, I have considered the governance arrangements that will be in place following the Transfer. I have taken into account that:

- The Transfer will significantly enhance the security of benefits for all M&G policyholders, and will not adversely affect the benefit expectations of the M&G policyholders
- The principles governing the future management of the M&G Sub-Fund have been set out in the Fundamentals of Financial Management as part of the terms of the Transfer
- As part of the Transfer, SF will set up a Monitoring Committee, a sub-committee of the SF Board responsible for providing oversight over the management and operations of the M&G Sub-Fund and monitoring adherence to the terms of the Transfer. I understand that the Monitoring Committee will be chaired by a Non Executive Director of SF and will have two members appointed by M&G. In my view this will provide a suitable mix of experience and perspective to enable it to carry out its obligations under its Terms of Reference, which I also consider appropriate. In my opinion, the existence of the Monitoring Committee (together with a provision for any member of the Monitoring Committee to notify the regulators of any matter he/she wishes to bring to its attention) provides significant additional comfort that appropriate governance processes will be in place for the management of policies in the M&G Sub-Fund post Transfer.
- The management of the M&G Sub-Fund will be governed by Principles and Practices of Financial Management ("PPFM") for the fund. This is a document

that provides a comprehensive description of how the relevant with-profits fund is managed, including a statement of the Principles and Practices adopted by the insurer in respect of a wide range of aspects relevant to the management of the fund in question. Based on my review as set out in the Report, I believe that the proposed new PPFM for the M&G Sub-Fund is reasonable and an accurate reflection of the terms of the Transfer.

Based on the above and my understanding that the existing governance arrangements for current SF policyholders will not be materially affected by the Transfer, in my opinion adequate safeguards are in place to ensure that the interests and rights of the policyholders of both M&G and SF will be protected post Transfer.

Following the Transfer, the administration of all the policies within the M&G Sub-Fund (currently undertaken by MGM Advantage Services Limited (“ServCo”)) will be transferred to SF. There is therefore a small risk that current SF and M&G policyholders could experience adverse changes to the standards of service following the Transfer as:

- The in-house SF administration team will be, at least initially, relatively inexperienced in administering M&G policies and have limited knowledge of the M&G products (in particular the FIA policies)
- Given the fixed cost agreement, SF may seek to minimise the costs associated with the administration of M&G policies which could also have a detrimental effect on the servicing of all policies

However, taking into account the provisions under the terms of the Transfer and the fact that the Monitoring Committee has the responsibility to monitor the fair treatment of policyholders in the M&G Sub-Fund, in my opinion, adequate provisions have been made under the terms of the Transfer to mitigate the risk of deterioration in standards of service experienced by both M&G and existing SF policyholders following the Transfer.

Furthermore, I have assessed and concluded that SF has a strong understanding of how FIA policies work, the risks associated with the product and can adequately administer these policies, taking into account that:

- SF has already conducted extensive operational due diligence on M&G’s product suite (in particular the FIA business) and a detailed IT and operational project plan is in place. In my opinion, SF has a strong understanding of the operational aspects of the FIA policies.
- At the time of my writing of this report, M&G and SF are already in advanced stage of information sharing in relation to the actuarial and financial aspects of the FIA business. I have also take into account that SF has a long established history of managing with-profits business and therefore will already be familiar

with general aspects of the product's with-profits elements. It is therefore my opinion that by the Effective Date, SF will have the necessary understanding and knowledge to manage the product from an actuarial and financial perspective.

- Furthermore, the required administrative processes for the FIA product are substantially similar to SF's existing requirements in relation to other products in its portfolio. I am therefore confident that SF can adequately administer these policies.

In my opinion, there has not been a material loss of membership benefits for the transferring M&G members as a result of the Transfer. The rights of SF members will not be affected by the Transfer.

Under the terms of the Transfer, the M&G Sub-Fund will be taxed as if it were a stand-alone mutual life insurance entity with the M&G Sub-Fund as its sole business.

Taking into account the considerations as set out in the Report, I am satisfied that the Transfer is not expected to have any significant adverse tax impact on the policyholders of SF and M&G, and that no changes are expected to the tax status of M&G policies as a result of the Transfer.

2.7. Main conclusions

Based on the analysis as summarised above and described in detail in the Report, I have made the following conclusions:

- The Transfer will significantly enhance the security of benefits for all M&G policyholders, and will not adversely affect the benefit expectations of the M&G policyholders
- The Transfer will not adversely affect the security of benefits or benefit expectations of the SF policyholders

3. The proposed Transfer

3.1. Background to M&G

M&G was established in 1852 and has been operating as a mutual life insurance company throughout its history. As a mutual firm it is owned by its members, which are primarily with-profits policyholders. It has written a wide range of life insurance and pension products including with-profits contracts as well as unit-linked and non-profit protection products. It is governed by the FSMA.

M&G had previously operated a subsidiary based in Dublin, MGM International Assurance, which sold with-profits business to policyholders in Germany, Belgium and the Netherlands. The subsidiary was closed to new business in 2009, and subsequently all policies were transferred into M&G. In the rest of this report I shall refer to these as “International Policies”.

Between 2008 and November 2013, M&G focused its new business sales efforts on pension annuity contracts following a strategic review in 2007 against the broader backdrop of a decline in new with-profits sales in the UK. Under the new strategy, M&G primarily sold two products:

- The Flexible Investment Annuity (“FIA”) – this is a with-profits investment linked annuity where the income is reviewed periodically and is subject to a guaranteed minimum amount. Policyholders retain investment control by choosing from a range of internal unit funds. Further details of FIA policies can be found in Appendix E.
- Enhanced Annuities (“EA”) – an annuity product offering a higher level of guaranteed annuity income based on individually underwriting the policyholder

These products, particularly the enhanced annuities, require significant levels of capital and as a mutual society M&G has limited means of raising additional capital. As result, despite these products being sold on terms profitable to M&G, it could not continue to support new business volumes at the same level while retaining sufficient capital to protect the security of benefits for its policyholders.

In response to these challenges, M&G entered into a transaction (the “ICE transaction”) with ICE Acquisitions S.A.R.L. (“ICE”), a company financed by funds managed by TDR Capital LLP, on 30th November 2013. This involved:

- The sale of M&G’s new business franchise, brand (“MGM Advantage”) and infrastructure
- The closure of M&G to new business
- Transfer of most of M&G’s staff to MGM Advantage Services Limited (“ServCo”)
- Entering into an administrative services agreement with ServCo under which M&G pays:

- A fixed annual per policy cost, guaranteed for 10 years from the date of transaction and increasing in line with the Retail Prices Index plus 1% per annum, plus
 - A fixed annual cost for 5 years from the date of transaction and increasing in line with the Retail Prices Index plus 1% per annum
- Reinsurance and subsequent Part VII transfer of all of M&G's EA business into MGM Advantage Life Limited ("MGMA") a new life insurance company owned by ICE
- Reinsurance of the unit funds of FIA policies into MGMA
- An associated Reinsurance Intermediation Agreement, under which M&G agreed to a contingent payment¹ to ICE in relation to the reinsurance agreements described above, conditional on sufficiently strong capital position at M&G and other specified circumstances including, inter alia, a transfer of the residual business of M&G to another insurer
- A goodwill payment from ICE to M&G of £9m which will be distributed to eligible with-profits members subject to sufficient surplus capital being available at M&G
- A formal Framework Agreement between M&G and its defined benefit staff pension plan, MGM Assurance Staff Pension Plan ("Staff Pension Plan") was agreed, involving an immediate contribution into the Staff Pension Plan and a commitment to make subsequent contribution of £9m following the distribution of the goodwill payment

The Part VII transfer of the EA business into MGMA was completed on 1st November 2014. The distribution of the goodwill payment and contribution to the Staff Pension Plan are expected to be completed by the end of 2014.

Following the completion of the ICE transaction and its closure to new business, M&G has focused on its revised business objectives as set out in its Strategic Report and Summary Financial Statements for the year ended 31st December 2013, to:

- Manage the business solely for the benefit of its existing members and policyholders
- Ensure adequate security for all policyholders
- Provide its customers with good and efficient service in relation to all aspects of the administration of their policies
- Ensure that its operations remain efficient and cost effective

¹ The contingent payment is £8m if repaid by 31 May 2015, increasing linearly to £12m over 5 years

The Board of M&G has therefore actively been investigating the possibility of transferring all or part of M&G's business to other insurance companies or friendly societies as an efficient strategy to achieve these objectives.

In November 2014, M&G completed a reinsurance agreement with RGA International to reinsure its Standard and Select annuity business that was not already covered by existing reinsurance arrangements. Under the terms of the agreement, RGA International assumed the responsibility for 100% of non-reinsured liabilities related to the policies in question in return for an upfront payment by M&G. M&G's primary purpose for entering into the agreement was to remove the longevity risk and credit risk related to its Standard and Select annuity business, but it also had the benefit of releasing capital associated with the block of business. Collateral arrangements are in place as part of the agreement, although M&G will still retain a partial counterparty credit risk exposure to RGA International following the reinsurance.

M&G has been investigating whether an arrangement with a third party for vesting pensions would be appropriate. This could help reduce the risks of the fund and assist with finding an equitable run-off. However, this is a relatively small element of the risk of the business and the volumes are expected to continue to reduce further following the Budget proposals in March 2014 to remove compulsory annuitisation of individual pensions, with further Budget changes expected from April 2015. As a result, this work may not be completed before the Transfer. However, any action available to M&G now would also be available to SF and its analysis of its risks has not assumed any benefit from this work.

A breakdown of the in-force policies for M&G at 31st December 2013 is set out in the table below:

Type of business	Number of policies	Pillar 1 liabilities ² (after reinsurance)
Conventional with-profits (life)	937	£10.4m
Conventional with-profits (pensions)	2,620	£77.0m
FIA	8,442	(£17.9m)
Unitised with-profits – other (UK)	6,722	£101.2m
Unitised with-profits – other (EU)	818	£26.3m
Unit-linked (unit reserves)	26,978	£405.6m
Non-profit – Standard and Select annuities	13,941	£299.7m
Non-profit – enhanced annuities	19,645	-
Non-profit – other	15,407	£5.3m
Total	95,510	£907.7m

Source: M&G PRA Returns as at 31st December 2013

² Peak 1 basis (see section 4.1 for further explanation)

The liabilities for the EA business are zero because it was fully reinsured to MGMA during 2013, and subsequently transferred to MGMA in November 2014. Similarly, the liability for the FIA business is negative because the unit funds have been fully reinsured to MGMA. The liability for unitised with-profits business includes £26.3m in relation to the International Policies.

Note that the figures in the table above do not allow for the Standard and Select annuities reinsurance which was not in force at 31st December 2013. The impact of the reinsurance would have been to reduce Pillar 1 liabilities (net of reinsurance and expenses) for the Standard and Select annuities to zero.

3.2. Background to SF

SF was established in 1862 as the City of Glasgow Friendly Society and was renamed Scottish Friendly Assurance Society in 1992, following the transfer of business from a Scottish-based mutual. As a Friendly Society it is owned by its members, and all Scottish Friendly policyholders are members. Today Scottish Friendly operates as a financial services group dedicated to the efficient provision of a wide range of financial products and services and continues to be based in Glasgow. It is governed by the Friendly Societies Act 1992.

SF has stated a “Diversify and Grow” strategy to generate long-term value for its members by:

- **Developing organic growth opportunities** - recent examples of organic growth initiatives are summarised below:
 - In December 2012, SF launched a new range of “My ISA” products which have grown to become its flagship savings and investments product and contributed to more than doubling of like-for-like new business sales in core products in SF from £8.5m in 2012 to £20m in 2013³
 - Development of a commercial whole of life product sold through a funeral plan provider
 - Diversification into the protection market in partnership with distributor brands such as BGL, Neilsons and Sun Life, leading to significant growth in such business

- **Capitalising on cost efficiencies within its administration by delivering business process outsourcing to partners** – for example:

³ Figures on Annual Premium Equivalent basis, which allows for 100% of regular premium sales and 10% of single premium sales

- In 2006, SF successfully launched a wrap administration business. By December 2011, the business had accumulated around £4bn in funds under administration and was bought by Citibank Global Transaction Services
- Partnership with BGL (the group behind “comparethemarket.com”) to launch Beagle Street, an online life insurance provider
- **Identifying merger and consolidation partners in the life sector.** SF has completed the following transfers of long-term insurance business in recent years:
 - On 31st December 2005, the life business of Rational Shelley Friendly Society Limited
 - On 31st May 2006, the life business of Preston Operative Assurance Collecting Society
 - On 1st July 2007, the life business of Pioneer Friendly Society Limited
 - On 30th September 2007, the life business of Scottish Legal Life Assurance Society Limited involving around 500,000 policyholders and funds of around £200m
 - On 31st December 2007, the life business of London Aberdeen & Northern Mutual Assurance Society Limited (“LANMAS”) involving around 6,000 policyholders and funds of around £37m
 - On 30th November 2012, the life business of Royal Standard Friendly Society

SF has the following fully-owned subsidiaries:

- **Scottish Friendly Asset Managers Limited:** conducts the business of managers for transactions in Scottish Friendly ISAs, PEPs and Child Trust Funds. At 31 December 2013 it had net asset value of £1.8m. It is still active but with limited new business.
- **Scottish Friendly Insurance Services Limited:** provider of third party administration and other services for the wrap business (which SF sold in 2011). At 31 December 2013 it had net asset value of £1.3m. It is much reduced in activity.
- **S.L. Insurance Services Limited:** agents for the transaction of general branch insurance. It is virtually dormant apart from some residual commission. At 31 December 2013 it had net asset value of £54,000.
- **SFIS (Nominees) Limited:** dormant

Taking into account the limited or dormant activity levels associated with the subsidiaries, I do not consider the subsidiaries listed above to be relevant or material to assessing the impact of the Transfer and therefore have not included them in my analysis.

SF currently operates a single Long Term Business Fund, which consists of the SF Main Fund and the following notional sub-funds:

- The Rational Shelley Sub-Fund
- The LANMAS Sub-Fund
- The Scottish Legal Sub-Fund

All sub-funds are closed to new business. Each sub-fund has a separate pool of assets, investment strategy, bonus rates and Principles and Practices of Financial Management (“PPFM”). The assets of each sub-fund are ring-fenced for the benefit of the policies within the sub-fund only. The SF Main Fund levies charges against each notional fund in line with the specified terms of the relevant transfers. Any profits emerging from administering the business within the notional funds accrues to the SF Main Fund. A breakdown (by fund and business type) of the in-force policies for SF at 31st December 2013 is set out in the table below:

SF Main Fund

Type of business	Number of policies	Pillar 1 liabilities ⁴ (after reinsurance)
Conventional with-profits	135,941	£222m
Unitised with-profits	23,646	£38m
Unit-linked	20,151	£229m
Whole of life (with-profits and non-profit)	297,919	£41m
Non-profit	34,906	£17m
Total	512,563	£547m

⁴ Peak 1 basis (see section 4.1 for further explanation)

Scottish Legal Sub-Fund

Type of business	Number of policies	Pillar 1 liabilities (after reinsurance)
Conventional with-profits	135,448	£34m
Unitised with-profits	592	£3m
Unit-linked	2,257	£13m
Non-profit	482,278	£14m
Total	620,575	£64m

Rational Shelley Sub-Fund

Type of business	Number of policies	Pillar 1 liabilities (after reinsurance)
Conventional with-profits	1,473	£5m
Non-profit	2,333	£2m
Total	3,806	£7m

LANMAS Sub-Fund

Type of business	Number of policies	Pillar 1 liabilities (after reinsurance)
Unitised with-profits	1,396	£7m
Unit-linked	1,018	£8m
Non-profit	344	£1m
Total	2,758	£17m

Source: SF PRA Returns as at 31st December 2013, SF AFH report on the Transfer

As shown in the table above, the SF Main Fund (with liabilities of over £500m) is significantly larger than the three sub-funds (with aggregate liabilities of less than £90m). It also functions as provider of working capital for SF. Among the sub-funds, the Scottish Legal Sub-Fund is the largest with liabilities of £64m.

SF has confirmed that other than the Transfer, there are no material planned transactions that I should be aware of when performing my review on the Transfer.

3.3. Overview of the Transfer

The key terms of the Transfer are set out below:

- All assets and the business of M&G (excluding unit-linked and term assurance business) will be transferred to a newly established fund (the “M&G Sub-Fund”)

within SF, which will operate as a closed with-profits fund, ring-fenced from the other funds of SF

- The assets and liabilities of the unit-linked and term assurance business will be transferred to the SF Main Fund. The amount of assets transferred will be based on defined components of liability for the transferring business, as published in the annual returns submitted to the PRA (“PRA Returns”) as at 31st December 2014, adjusted for the period from that date until the Effective Date.
- The SF Main Fund will pay £10m into the M&G Sub-Fund
- SF will charge the M&G Sub-Fund fixed per policy annual administration fees in respect of the transferring policies (the level of charges depends on the type of policies). The per policy fees will apply for the entire duration of the policy and increase annually in line with the Average Weekly Earnings Index published by the Office of National Statistics⁵.
- SF will also charge the M&G Sub-Fund an annual investment management charge of 0.2% per annum with respect to assets invested in the M&G Sub-Fund (excluding assets backing the FIA unit funds)
- SF will assume the role of statutory employer with respect to the Staff Pension Plan. However, the cost of funding the Staff Pension Plan will be fully allocated to the M&G Sub-Fund.
- SF will provide capital support to the M&G Sub-Fund in the event of a capital shortfall. The charge for this capital support to the M&G Sub-Fund will be 4% per annum for any amount under £10m and 6% per annum for any amount over £10m, above the base rate of Barclays Bank plc.
- The Transfer is conditional on M&G having at least a specified minimum level of solvency capital on a Pillar 2 basis at the Effective Date
- A Monitoring Committee will be established to provide independent oversight of the M&G Sub-Fund and oversee its integration. The committee will be made up of five members, three of which will be nominated by SF and two by M&G.
- All M&G policyholders will become members of SF. Where an individual is a beneficiary through a pension contract which is held under trust, the trustee is the policyholder (and the member of M&G currently) and will become a member (not the individual).

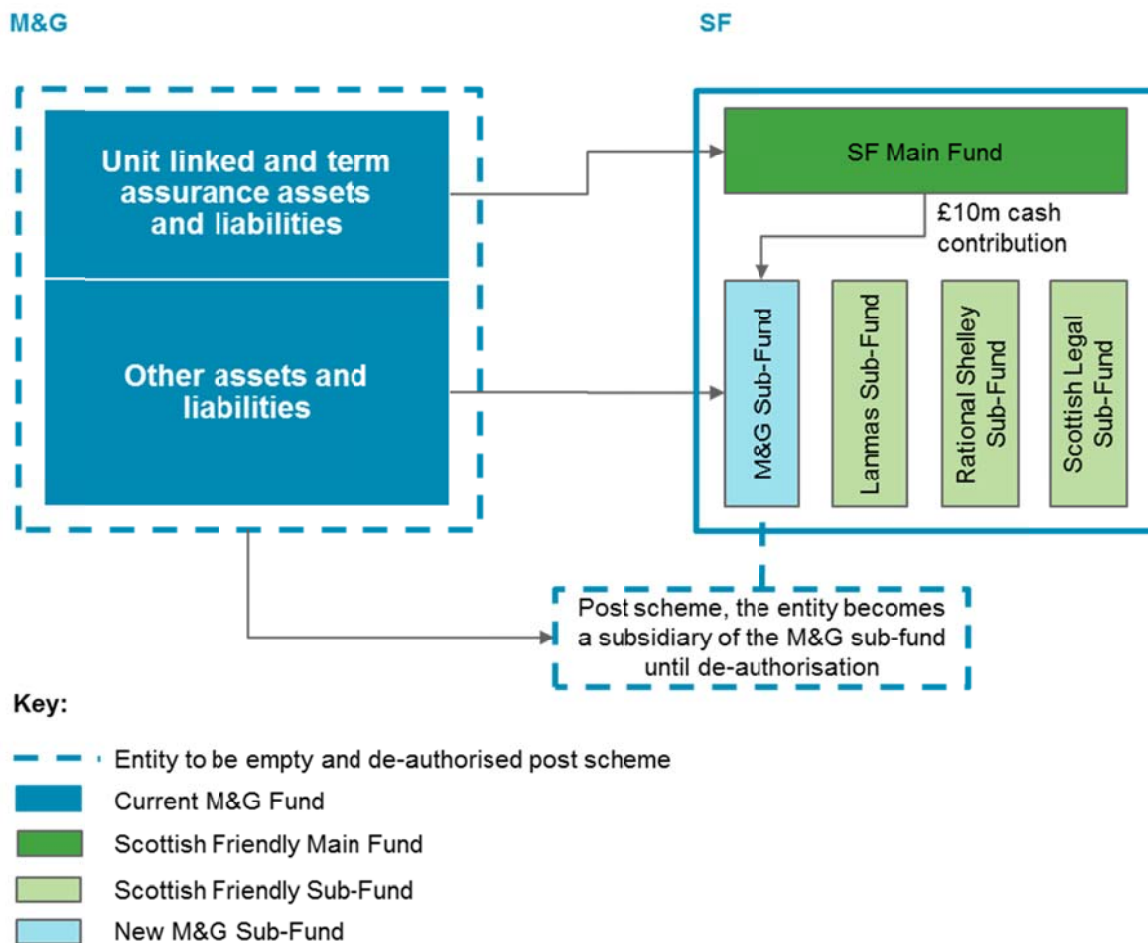
In addition, the following events will occur in conjunction with the Transfer:

⁵ The inflation linkage is different to M&G’s current arrangement with ServCo, where fixed per policy costs increase in line with Retail Prices Index plus 1% per annum. My analysis of historical data between January 2001 and March 2014 indicates that the average Retail Prices Index rate was 2.91% per annum compared against Average Weekly Earnings rate of 3.02%. It is therefore my opinion, that the inflation linkage for per policy costs under the Transfer terms is not materially worse than the status quo.

- Prior to Transfer, M&G will pay a break fee of up to £10m to ServCo in order to terminate the existing administrative services agreement
- Prior to Transfer, M&G will pay ICE £8m in relation to the contingent payment which would be triggered upon the completion of the Transfer, in order to terminate the Reinsurance Intermediation Agreement with ICE

Under the terms of the Transfer, the current members of M&G will give up their membership and voting rights in M&G at the Effective Date. Immediately after that, SF will be granted sole membership of M&G and become responsible for the governance and administration of M&G while it continues in existence until it can be formally dissolved.

An illustrative diagram of the Transfer is shown below:



Note: M&G has a subsidiary, MGM Assurance (Trustees) Limited (not shown in the diagram), which will become a subsidiary of SF; it has an issued share capital of £1,000 and a de-minimis value which

would be attributed to the M&G Sub-Fund. I do not consider the subsidiary to be relevant or material to assessing the impact of the Transfer.

Following the Transfer, a breakdown (by fund and business type) of the in-force policies for SF at 31st December 2013 is set out in the table below:

SF Main Fund (post Transfer)

Type of business	Number of policies	Pillar 1 liabilities ⁶ (after reinsurance)
Conventional with-profits	135,941	£222m
Unitised with-profits	23,646	£38m
Unit-linked	47,129	£635m
Whole of life (with-profits and non-profit)	297,919	£41m
Non-profit	50,313	£22m
Total	554,948	£958m

M&G Sub-Fund (post Transfer)

Type of business	Number of policies	Pillar 1 liabilities (after reinsurance)
Conventional with-profits (life)	937	£10m
Conventional with-profits (pensions)	2,620	£77m
FIA	8,442	(£18m)
Unitised with-profits – other (UK)	6,722	£101m
Unitised with-profits - other (EU)	818	£26m
Total	19,539	£197m

Scottish Legal Sub-Fund (post Transfer)

Type of business	Number of policies	Pillar 1 liabilities (after reinsurance)
Conventional with-profits	135,448	£34m
Unitised with-profits	592	£3m
Unit-linked	2,257	£13m
Non-profit	482,278	£14m
Total	620,575	£64m

⁶ Peak 1 basis (see section 4.1 for further explanation)

Rational Shelley Sub-Fund (post Transfer)

Type of business	Number of policies	Pillar 1 liabilities (after reinsurance)
Conventional with-profits	1,473	£5m
Non-profit	2,333	£2m
Total	3,806	£7m

LANMAS Sub-Fund (post Transfer)

Type of business	Number of policies	Pillar 1 liabilities (after reinsurance)
Unitised with-profits	1,396	£7m
Unit-linked	1,018	£8m
Non-profit	344	£1m
Total	2,758	£17m

Source: SF PRA Returns as at 31st December 2013, SF AFH report on the Transfer

Both managements and Boards of SF and M&G are supportive of the Transfer and believe that the Transfer will have a positive impact on their respective members and policyholders.

M&G's Board has highlighted the following aspects of the Transfer:

- It believes that M&G policyholders will be transferring to a stronger insurer and hence the security of benefits will be enhanced by the Transfer
- It is confident that SF will provide an efficient and customer-centred service to M&G policyholders
- The contribution to the M&G Sub-Fund of £10 million in respect of the unit-linked and term assurance business improves the capital position and stability of the fund and assists in the distribution of capital to with-profits policyholders
- The charges for expenses that can be made to the M&G Sub-Fund by the Main Fund are significantly less than the current fees paid to ServCo. In addition there is much greater certainty over what items are included in these charges. This, coupled with the removal of the direct costs incurred by M&G, leads to an expectation of future expense savings in excess of £30 million after allowing for the costs of the transaction including the various payments to ICE.
- Due to the financial strength of SF and lower level of uncertainty around M&G's future operation, the Board believes that it will be possible to start making distributions of capital to M&G's with-profits policies much sooner than would be the case without the Transfer

- There is no change to M&G's current obligations to the Staff Pension Plan, with these obligations becoming the responsibility of the M&G Sub-Fund

The Actuarial Function Holder / With-Profits Actuary of M&G has made the following conclusions on the Transfer in his report:

- The Transfer is likely to improve the security of the benefits under the transferring policies
- The Transfer will not have an adverse effect on the benefit expectations for the transferring policies
- There is unlikely to be a change in the quality of the administration of the transferring policies due to the Transfer
- The terms of the Transfer do not conflict with the requirements of the PPFM and, in particular, the Board's use of its discretionary power in agreeing to proceed with the Transfer is fair and appropriate
- Implementing the Transfer will have no adverse effect on the reasonable benefit expectations of with-profits policyholders established in line with the PPFM and will enhance their benefit expectations in the context of the enhanced ability to distribute M&G's capital to with-profits policyholders from the M&G Sub-Fund.
- The proposed PPFM and FFM for the Transfer represent an appropriate framework for the future management of the M&G Sub-Fund and will ensure continuity and consistency

SF has highlighted the following aspects of the Transfer to its Delegates:

- The Transfer represents a particularly significant opportunity in line with SF's overall strategy (as described in section 3.2)
- The Transfer adds significant scale to SF's business
- It believes that the benefits of the Transfer can be achieved within acceptable risk parameters for SF given the ring-fenced structure, the reinsurance arrangements in place, the similarity with SF's own business, the shared IT platform, SF's prior experience of transfers and established efficiencies which enables SF to take M&G's business on with only a small increase in headcount and infrastructure
- The SF 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. In each case the Board is satisfied that the risks are judged to be within SF's agreed risk appetite, with plans for due mitigation.

The Actuarial Function Holder of SF has identified the following as the main benefits of the Transfer to the policyholders of SF in his report:

- Provide value to the SF Main Fund from the transfer of the unit-linked and term assurance business
- Provide value to the SF Main Fund from margins in administering the M&G Sub-Fund business
- Provide economies of scale from transferred business

The With-Profits Actuary of SF has made the following conclusions on the Transfer in his report:

- The proposed Transfer does not have any adverse impact on the existing with-profits policyholders of SF
- The transfer does not introduce any significant additional operational risks into SF which could adversely affect the interests of the existing members
- There will be no detriment to the administration of the existing policies as a result of the Transfer

The With-Profits Actuary therefore concludes that there is no reason, in terms of maintaining the interests of existing with-profits policyholders, why the transfer should not proceed.

I have reviewed the reports of the Actuarial Function Holder and With Profits Actuary of M&G and SF respectively and I agree with the views expressed in those reports.

3.4. Reinsurance arrangements

The following table summarises M&G's material reinsurance agreements in place at 31st December 2013. M&G also has other reinsurance agreements (with aggregate reinsurance liabilities of less than £0.1m) but I have not included these in the report on grounds of materiality:

Reinsurer	Business covered	Reinsured Pillar 1 liabilities 31 st Dec 2013
MGM Advantage Life	EA business written after June 2008	£892.8m
MGM Advantage Life	Unit funds of FIA business	£458.4m
Hannover Ruckversicherungs- Aktiengesellschaft	Semi-underwritten annuity business ("Select annuities" written before June 2004)	£61.5m
Pacific Life Re	Vesting annuities ("Standard annuities") from internal pension	£7.6m

	business written before July 2009	
Hannover Life Re (Ireland)	Selected term assurance, critical illness and waiver of premium business	£1.7m
Munich Reinsurance	Selected term assurance business	£0.7m
Swiss Re	Selected term assurance and critical illness business	£0.5m
Hanover Life Re UK	Selected term assurance, critical illness and waiver of premium business	£0.2m

Source: M&G PRA Returns as at 31st December 2013

Following the completion of the transfer of the EA business to MGMA on 1st November 2014 under Part VII of FSMA, the associated reinsurance agreement described in the table above is no longer in force. It should also be noted that subsequent to 31st December 2013, M&G entered into a reinsurance agreement with RGA International covering its Standard and Select annuities (see section 3.1).

Under the terms of the Transfer, all of M&G's existing reinsurance arrangements will be novated across to SF. I shall provide an update on M&G's progress in obtaining reinsurer consent for novating the relevant reinsurance arrangements in my supplementary report.

The following table summarises SF's reinsurance agreements in place at 31st December 2013 where the reinsured liabilities exceeded £10m. SF also has other reinsurance agreements where the reinsured liabilities amounted to less than £10m, but I have not included these in the report on grounds of materiality:

Reinsurer	Business covered	Reinsured Pillar 1 liabilities 31 st Dec 2013
Swiss Re	Selected protection business (Smart / British Seniors)	£45.6m
Hannover Re	Selected protection business (Beagle Street)	£15.9m

Source: SF PRA Returns as at 31st December 2013

SF's reinsurance agreements will not be affected by the Transfer.

4. Financial position pre and post Transfer

In this section, I consider the financial impact of the Transfer under three separate solvency bases: two of these (Pillar 1 and Pillar 2) are currently in force while the third (Solvency 2) is expected to come into effect on 1st January 2016. Section 4.1 provides further background and context.

4.1. Background and overview

UK insurance companies are currently regulated by the PRA and the FCA. The PRA is responsible for promoting the safety and soundness of financial services firms and, specifically for insurers, to contribute to the securing of an appropriate degree of protection for policyholders. The FCA's aim is to protect consumers, ensure the industry remains stable and promote healthy competition between providers.

The PRA's regulatory regime aims to protect policyholders and ensure that insurance companies are adequately capitalised. The risk of insurers failing to meet their obligations is minimised as far as possible, while recognising that it is not practicable to operate a "zero failure" regime. Insurers must demonstrate solvency to the PRA under two separate measures – Pillars 1 and 2.

4.1.1. Pillar 1 rules

An insurer must report on its Pillar 1 solvency position as part of its PRA Returns, which is a publicly available document. The PRA Returns must demonstrate that the insurer holds Available Capital⁷ in excess of the "Capital Resources Requirement" ("CRR"). The excess of Available Capital over CRR is commonly known as the "Free Assets". The Regulatory Handbook sets out prescriptive rules and guidance on appropriate methodology and assumptions for a Pillar 1 valuation.

Firms which have with-profits business in excess of £500m are required to report their Pillar 1 solvency position on the more onerous of two separate bases: i.e. "Peak 1" and "Peak 2".

Under Peak 1, the assets are based on market values (subject to certain admissibility restrictions) and the liabilities are calculated on prudent assumptions (but without allowance for liabilities which are not guaranteed such as future bonuses on with-profits policies and certain contingent payments). The CRR is broadly calculated as a fixed percentage of the value of Peak 1 liabilities.

⁷ Available Capital is calculated as the excess of the regulatory value of assets over the regulatory value of liabilities

Under Peak 2, the assets are also based on market values but some assets which are not admissible under Peak 1 may be taken into account. The liabilities are calculated on realistic assumptions (with allowance for future bonuses on with-profits policies) and the capital requirement is calculated based on defined stress scenarios. If the Peak 2 solvency position is more onerous, a With-Profits Insurance Capital Component (“WPICC”) is added to the CRR.

4.1.2. Pillar 2 rules

The PRA requires each insurer to perform an Individual Capital Assessment (“ICA”) to demonstrate that it has sufficient capital to meet liabilities in adverse circumstances, taking into account its own assessments of the risks faced. The risks faced by the insurer are explicitly considered and capital held to support each risk. The regulations require that the insurer must hold capital such that it is 99.5% confident that the value of assets will be higher than the value of liabilities over a one year timeframe.

Unlike for Pillar 1, the PRA does not provide detailed rules on methodology and assumptions for a Pillar 2 valuation. Each firm can develop its own ICA using the methodology and assumptions it deems to be appropriate for its business, subject to review by the PRA.

The ICA is submitted to the PRA but is not publicly disclosed. The PRA in turn issues Individual Capital Guidance (“ICG”) to the insurer, which sets out the PRA’s view of the amount and quality of capital it believes the insurer needs to hold.

4.1.3. Solvency 2

A new EU-wide regulatory regime for the insurance industry, known as “Solvency 2”, is currently being developed. The PRA has stated that the current regulatory framework will remain in place for insurers until Solvency 2 comes into effect which is expected to be 1st January 2016.

The principles behind Solvency 2 are similar to the Pillar 2 rules in that each insurer must hold capital such that it is 99.5% confident that the value of assets will be higher than the value of liabilities over a one year timeframe, however there are also technical differences which are beyond the scope of this report. The technical rules underlying Solvency 2 are currently under consultation by the European Commission and the European Insurance and Occupational Pensions Authority (“EIOPA”), an organisation comprising local insurance and pension regulators in the EU. The PRA is a member of EIOPA. This new regulatory regime is likely to result in significant changes to the capital requirements of insurers and there will be substantial differences in terms of how Solvency 2 impacts different insurers.

In section 4.4, I consider the potential impact of the Transfer based on the latest draft technical rules for Solvency 2. However, it must be noted that while the overall framework and principles have been laid out by the rule setters, the technical rules

remain under consultation and there is insufficient clarity at the time of writing this report to draw any firm conclusions on the exact implications for each insurer at this stage. This is particularly true of annuity business where there is currently much discussion about the interest rate that can be used when discounting future liabilities to the present date. However, SF does not currently have a significant exposure to annuities. The same is also true for M&G following the completion of the reinsurance agreement with RGA International with respect to Standard and Select annuities.

Furthermore, there will be transitioning provisions that allow insurers the option of “phasing-in” the impact of certain aspects of Solvency 2 over a period of up to 16 years. Subject to regulator approvals, insurers will be allowed to gradually move from their current solvency regime to Solvency 2 requirements over 16 years, with the weighting applied to Solvency 2 increasing linearly over time. There are two types of transitional provisions currently envisaged under the draft rules, one relating to discount rates used for technical provisions and the other relating to the technical provisions itself.

At the time that this report was being drafted, the latest significant development regarding Solvency 2 related to the adoption and publication of the Delegated Acts containing implementing rules for Solvency 2 by the European Commission on 10th October 2014. These are subject to scrutiny and approval by the European Parliament and Council, which can take up to a period of six months.

4.2. Financial impact of the Transfer on Pillar 1 basis

For the Pillar 1 position, SF and M&G are currently required by the regulations to perform Peak 1 and Peak 2 calculations as both companies have with-profits funds in excess of £500m.

SF's reported financial position as at 31st December 2013 is summarised below:

£m	SF Main Fund	SL Sub-Fund	LANMAS Sub-Fund	RS Sub-Fund	SF Total
Peak 1 calculations					
Assets	688.1	100.3	25.2	10.0	823.6
Liabilities	(562.3)	(68.4)	(17.7)	(6.8)	(655.2)
Available Capital	125.8	31.9	7.5	3.2	168.4
Capital Requirement	(20.6)	(2.5)	(0.4)	(0.3)	(23.8)
Free Assets	105.2	29.4	7.1	2.9	144.6
Peak 2 calculations					
Assets	688.4	100.2	25.3	10.0	
Liabilities (excluding planned enhancements)	(604.1)	(78.6)	(21.8)	(8.5)	
Planned enhancements	0.0	(21.6)	(3.5)	(1.5)	
Available Capital	84.3	0.0	0.0	0.0	
Capital Requirement	7.1	0.0	0.0	0.0	
Free Assets	77.3	0.0	0.0	0.0	
Reported Pillar 1 position					
Assets	688.1	100.3	25.2	10.0	823.6
Liabilities	(562.3)	(68.4)	(17.7)	(6.8)	(655.2)
Available Capital	125.8	31.9	7.5	3.2	168.4
Capital Resources Requirement	(48.5)	(31.9)	(7.5)	(3.2)	(91.1)
Free Assets	77.3	0.0	0.0	0.0	77.3

Source: SF PRA Returns as at 31st December 2013

Note that:

- Under the Peak 2 regulations, each of the sub-funds within SF is classified as a closed with-profits fund and would be required to report zero Peak 2 Free Assets in the PRA returns. This is because any excess capital within the sub-fund would be ultimately distributed to existing policies in that sub-fund, and therefore would be classified as "planned enhancements" in the PRA returns.
- For presentational reasons and to aid comparability with Peak 1 figures, we have included the realistic value of non-profit liabilities in both the assets and liabilities under the Peak 2 calculations

In addition to analysing the absolute figures from the PRA Returns, it is also useful to calculate solvency ratios on both the Peak 1 and Peak 2 for each sub-fund, as they provide a simple yardstick for comparing financial positions between sub-funds and the impact of any changes to the sub-funds (or the insurer as a whole). For the purposes of this report I have calculated the following two ratios:

- **Peak 1 Capital Ratio:** calculated as Peak 1 Available Capital divided by Peak 1 Liabilities
- **Peak 2 Capital Ratio:** calculated as Peak 2 Available Capital plus “planned enhancements” divided by Peak 2 Liabilities (including non-profit business)

SF’s solvency ratios based on reported financial position as at 31st December 2013 is summarised below:

	SF Main Fund	SL Sub-Fund	LANMAS Sub-Fund	RS Sub-Fund	SF Total
Peak 1 Capital Ratio	22%	47%	42%	47%	26%
Peak 2 Capital Ratio	14%	27%	16%	18%	n/a

Source: Oliver Wyman analysis

The figures indicate that SF was in a strong solvency position as at 31st December 2013, with a high level of Free Assets under both Peak 1 and Peak 2 basis. The table also shows that Peak 2 was more onerous for the SF Main Fund by a significant margin, and was therefore the biting regulatory constraint pre Transfer. This would continue to be the case post Transfer, as can be seen later in this section.

It should be noted that while the sub-funds are significantly smaller than the SF Main Fund, each sub-fund is in a strong solvency position with higher Peak 1 and Peak 2 Capital Ratios as at 31st December 2013 when compared against the SF Main Fund.

M&G's reported financial position and solvency ratios as at 31st December 2013 are summarised below (with liabilities and Peak 1 capital requirements for the unit linked and term assurance business split out for information):

£m	Unit linked and term assurance	Other	M&G Total
Peak 1 calculations			
Assets			1,101.7
Liabilities	(396.9)	(614.8)	(1,011.7)
Available Capital			90.0
Capital Requirement	(2.0)	(66.9)	(68.9)
Free Assets			21.1
Peak 2 calculations			
Assets			1,101.7
Liabilities (excluding planned enhancements)	(392.9)	(643.1)	(1,036.0)
Planned enhancements			(65.7)
Available Capital			0.0
Capital Requirement			0.0
Free Assets			0.0
Reported Pillar 1 position			
Assets			1,101.7
Liabilities	(396.9)	(614.8)	(1,011.7)
Available Capital			90.0
Capital Resources Requirement			(90.0)
Free Assets			0.0
Source: M&G PRA Returns as at 31 st December 2013			
			M&G Total
Peak 1 Capital Ratio			9%
Peak 2 Capital Ratio			6%

Source: Oliver Wyman analysis

M&G is closed to new business other than for increments and where required to issue new policies under the terms of existing contracts (or potentially in respect of the Staff Pension Plan). Therefore, in a similar manner to SF's sub-funds, any excess capital under Peak 2 is classified as "planned enhancements" because it would be ultimately distributed to the remaining policies. However, in the absence of "planned enhancements", Peak 1 would have been the biting solvency constraint for M&G as it would have had less Peak 1 Free Assets (relative to the Peak 2 position).

A pro-forma post Transfer combined financial position and solvency ratios as at 31st December 2013 are summarised below:

£m	SF Main Fund	M&G Sub-Fund	SL Sub-Fund	LANMAS Sub-Fund	RS Sub-Fund	SF Total (post Transfer)
Peak 1 calculations						
Assets	1,071.0	385.0	100.3	25.2	10.0	1,591.5
Liabilities	(935.2)	(305.0)	(68.4)	(17.7)	(6.8)	(1,333.1)
Available Capital	135.9	80.0	31.9	7.5	3.2	258.5
Capital Requirement	(24.6)	(37.0)	(2.5)	(0.4)	(0.3)	(64.8)
Free Assets	111.2	43.0	29.4	7.1	2.9	193.7
Peak 2 calculations						
Assets	1,073.1	385.0	100.2	25.3	10.0	
Liabilities (excluding planned enhancements)	(978.4)	(330.0)	(78.6)	(21.8)	(8.5)	
Planned enhancements	0.0	(55.0)	(21.6)	(3.5)	(1.5)	
Available Capital	94.7	0.0	0.0	0.0	0.0	
Capital Requirement	7.1	0.0	0.0	0.0	0.0	
Free Assets	87.6	0.0	0.0	0.0	0.0	
Reported Pillar 1 position						
Assets	1,071.0	385.0	100.3	25.2	10.0	1,591.5
Liabilities	(935.2)	(305.0)	(68.4)	(17.7)	(6.8)	(1,333.1)
Available Capital	135.9	80.0	31.9	7.5	3.2	258.5
Capital Resources Requirement	(48.2)	(80.0)	(31.9)	(7.5)	(3.2)	(170.8)
Free Assets	87.6	0.0	0.0	0.0	0.0	87.6

Source: SF and M&G analysis

	SF Main Fund	M&G Sub-Fund	SL Sub-Fund	LANMAS Sub-Fund	RS Sub-Fund	SF Total (post Transfer)
Peak 1 Capital Ratio	15%	26%	47%	42%	47%	19%
Peak 2 Capital Ratio	10%	17%	27%	16%	18%	

Source: Oliver Wyman analysis

Note that SF's expected cost savings are reflected in the solvency figures for the SF Main Fund. In addition the figures include allowances for the payment of the break

fee to ServCo and payment of £8m to ICE in relation to the Reinsurance Intermediation Agreement, as described in section 3.3.

In performing these calculations, SF and M&G have made the following key assumptions:

- The reinsurance of Standard and Select annuities came into effect retrospectively at 31st December 2013
- The Part VII transfer of the EA policies to MGMA came into effect retrospectively at 31st December 2013
- Distribution of £9m to M&G members and payment of £9m into the Staff Pension Plan was made at 31st December 2013

In my opinion this is not an unreasonable basis on which to draw my conclusions concerning the relative financial strengths of the SF Main Fund and the four sub-funds following the transfer.

The following observations and comments are relevant in relation to the Pillar 1 financial impact:

- The overall size of SF would grow significantly, with total assets (net of existing reinsurance arrangements) doubling from £0.8bn to £1.6bn
- The financial position of SF's existing sub-funds are unchanged due to the ring-fenced nature of the funds
- The SF Main Fund would grow in size as a result of the transfer of unit-linked and term assurance business from M&G. Its solvency would be strengthened, with Free Assets increasing under both Peak 1 and Peak 2. This is mainly because of the expense margins it expects to make in administering the M&G policies as a result of the Transfer. Peak 2 remains the biting constraint for the fund.
- The SF Main Fund's Peak 1 Capital Ratio would fall from 22% to 15% as a result of the Transfer. Its Peak 2 Capital Ratio would also fall from 14% to 10% as a result of the Transfer. This is primarily due to the transfer of unit-linked business which increases the size of liabilities by around £400m. In my opinion, this does not signal a weakening of the SF Main Fund's solvency position, because unit-linked business requires a much lower level of Available Capital to support its operation (when compared against with-profits business) due to the absence of investment guarantees. Therefore, in my opinion, policyholders in the SF Main Fund would not be materially adversely impacted by the reduction in Capital Ratios. Indeed, if the unit-linked liabilities are excluded, the Peak 1 and Peak 2 Capital Ratios would be 25% and 16% respectively following the Transfer, i.e. higher than the corresponding figures before the Transfer.

- The Peak 1 Free Assets for M&G improves significantly following the Transfer, driven by the combination of significant cost savings arising from the Transfer and the £10m contribution from SF.
- The reported Peak 2 Free Assets for the M&G Sub-Fund would be zero. This is because the excess Peak 2 capital is classified as “planned enhancements” under the regulations. I consider this effect to be mainly presentational, as it does not actually change the true financial position of the funds.
- The level of “planned enhancements” is lower compared to the year-end position. However, this largely reflects events prior to the Transfer, including the £9m distribution to members and the reinsurance of the standard annuities (which reduced liabilities by roughly a third). When viewed in isolation, the Transfer results in an increase in Peak 2 Free assets of £19m. This is discussed further in Appendix F.
- In terms of solvency ratios, M&G’s solvency position would improve following the Transfer. Its Peak 1 Capital Ratio would increase from 9% to 26% as at 31st December 2013, and similarly its Peak 2 Capital Ratio increases from 6% to 17%.
- Furthermore, I understand that SF has no intention to reduce target capital levels for the M&G Sub-Fund following the Transfer.

4.3. Financial impact of the Transfer on Pillar 2 basis

M&G provided a detailed analysis of the impact of the Transfer on its ICA position as at 31st December 2013. The figures were calculated assuming that the same ICA methodology would apply pre and post Transfer and focus on the result without the effects of any ICG issued by the PRA to M&G. I have reviewed the underlying methodology and assumptions behind the analysis and consider them to be reasonable.

An insurer’s Pillar 2 capital position is not publicly disclosed and contains commercially sensitive information. Due to this commercial sensitivity I have avoided quoting the full detailed results of M&G’s analysis in my report. However, the results do indicate that the Pillar 2 Free Assets of the M&G Sub-Fund following the Transfer will increase materially when compared against the pro-forma pre-Transfer Pillar 2 position. This is driven by a combination of:

- Expected future expense savings as a result of the Transfer, partially offset by the project costs associated with the Transfer
- The net effect of Transfer related cash flows as set out in section 3.3
- Reduction in Pillar 2 capital requirements as a result of increased cost certainty as a result of the Transfer

This indicates that the Transfer would be beneficial to the policyholders of M&G in terms of the Pillar 2 financial position. The analysis also showed that the M&G Sub-Fund would retain a healthy level of Pillar 2 Free Assets after the Transfer.

SF's overall Pillar 2 financial position remains broadly unchanged following the Transfer, with its Pillar 2 Available Capital, Capital Requirements and Free Assets all increasing roughly in proportion to the increase in the total liabilities of the company.

SF also performs a separate ICA calculation for the SF Main Fund and each of the sub-funds. The SF Main Fund's Pillar 2 position will improve as a result of the expected expense savings following the Transfer. Due to their ring-fenced nature, the Pillar 2 position of the sub-funds will not be affected by the Transfer.

4.4. Financial impact of the Transfer under Solvency 2

I have received from both SF and M&G their submissions to the PRA which show their respective financial positions as at 31st December 2013 under the latest draft technical rules underpinning the latest data collection exercise undertaken by the PRA. I have further received additional analyses from SF covering the estimated post Transfer combined financial position as at 31st December 2013, as well as additional analyses from M&G on the position of the M&G Sub-Fund on a standalone basis post Transfer.

The analyses show that SF and M&G both expect the Transfer to significantly improve the financial position under Solvency 2. Furthermore, the information provided suggests that SF expects each of the respective sub-funds (including the M&G Sub-Fund and SF Main Fund) to be able to comfortably cover the capital requirements of Solvency 2 (defined as the "Solvency Capital Requirement" under Solvency 2).

In the event that the M&G Sub-Fund is at risk of being unable to cover its Solvency Capital Requirements, further management actions could be taken to preserve the solvency of the M&G Sub-Fund. For example, the Solvency Capital Requirement would be lower if planned management actions are in place in the event of adverse scenarios occurring which would threaten solvency. In the event that the M&G Sub-Fund is unable to cover its Solvency Capital Requirements, SF is committed under the terms of the Transfer to provide capital support to the M&G Sub-Fund.

I have reviewed the analyses provided and consider them to be reasonable. It must however be noted that the rules applicable under Solvency 2 remain in draft form and could be subject to changes. The above therefore cannot be relied upon for the actual financial position for the combined entity when Solvency 2 comes into force. However, I do not expect any major changes in the proposed Solvency 2 rules which would jeopardise the solvency position of SF or the M&G Sub-Fund after the Transfer.

I shall continue to monitor the developments in Solvency 2 and assess their implications for the Transfer, and will provide an update (and, where appropriate, the effect of any significant developments on the Transfer) in a supplementary report if necessary.

4.5. Conclusions

In this section I have considered the financial impact of the Transfer under three separate solvency bases.

In relation to the Pillar 1 financial impact, I have concluded that:

- The financial position of SF's existing sub-funds are unchanged due to the ring-fenced nature of the funds
- The SF Main Fund would grow in size as a result of the transfer of unit-linked and term assurance business from M&G. Its solvency position would be strengthened, with Free Assets increasing under both Peak 1 and Peak 2. This is mainly because of the expense margins it expects to make in administering the M&G policies as a result of the Transfer.
- The Peak 1 Free Assets for M&G (the Sub-Fund after the Transfer) improves significantly following the Transfer, driven by the combination of significant cost savings arising from the Transfer and the £10m contribution from SF.
- The Transfer results in an increase in Peak 2 excess capital of £19m.

In relation to the Pillar 2 financial impact, I have concluded that:

- The Transfer would be beneficial to the policyholders of M&G in terms of the Pillar 2 financial position and the M&G Sub-Fund would retain a healthy level of Pillar 2 Free Assets after the Transfer.
- The SF Main Fund's Pillar 2 position will improve as a result of the expected expense savings following the Transfer. Due to their ring-fenced nature, the Pillar 2 position of the sub-funds will not be affected by the Transfer.

In relation to the Solvency 2 financial impact, I have concluded that:

- The Transfer will significantly improve the financial position under Solvency 2, based on the current draft rules applicable under Solvency 2.

5. Financial effect of the Transfer on M&G policyholders

5.1. Overview

In this section, I have considered the financial effect of the Transfer on the following groups of M&G policyholders:

- FIA policyholders
- Other with-profits policyholders
- Non-profit policyholders
- Unit-linked policyholders

I have assessed the impact of the Transfer on all groups of policyholders in terms of security of benefits. I have also assessed how the Transfer would affect the investment strategy and expense charges with respect to with-profits, FIA and unit-linked policyholders. Finally, I have considered the implications of the Transfer for the benefit expectations and bonus prospects for with-profits and FIA policyholders.

I have taken into account discretionary elements of the current charges applied to each group of with-profits policyholders in M&G, as set out in the PPFM and summarised below:

Group	Current expense charges to asset shares	Guarantee or smoothing charges
Conventional WP	Variable based on costs attributable to conventional WP	None
Unitised WP	Defined in accordance with policy literature (increasing in line with actual expenses incurred)	None
International	Defined in accordance with policy literature (increasing in line with actual expenses incurred)	None
FIA	Defined in accordance with policy literature (increasing in line with actual expenses incurred)	Regular (variable) charge for minimum income guarantee

There is additionally discretion around profit participation rights through the declaration of bonuses and the approach to setting and smoothing bonuses is set out in the PPFM.

There is currently no expectation of additional profit participation rights among with-profit policyholders and this has been made explicit in the PPFM.

The level of premiums payable for all policies will not be affected by the Transfer. Due to the contractual nature of non-profit business, the benefits of non-profit policies will not be affected by the Transfer and therefore will not be covered further in the rest of this chapter.

5.2. Security of benefits

Following the Transfer, the assets and liabilities of M&G (excluding those relating to the unit-linked and term assurance business) will be transferred to the M&G Sub-Fund, which is ring-fenced from the other long-term funds maintained by SF. My analysis in section 4.2 indicates that the Transfer would immediately result in a significant improvement in the M&G Sub-Fund's solvency position under both the Peak 1 and Peak 2 bases. As discussed in sections 4.3 and 4.4, analysis undertaken by M&G indicates that the same is also true in respect of the Pillar 2 and Solvency 2 valuation bases.

Although SF intends to manage the M&G Sub-Fund on a self-sufficient basis, there are provisions under the terms of the Transfer for the sub-fund to be provided with capital support by the SF Main Fund if necessary (for example during periods of adverse financial or other conditions). The mechanics of the capital support is discussed further in section 6.1. This would provide an additional layer of security for the benefits in the M&G Sub-Fund.

M&G's unit-linked and term assurance policies will be transferred to the SF Main Fund. As shown in the solvency figures set out in section 4.2, the SF Main Fund is in a very strong financial position (with Free Assets of £77m) which in my view provides a higher level of benefit security compared to the status quo for those policies.

In addition to the above, the transferring policyholders would be part of a larger and more diverse organisation with a stronger solvency position and greater ability to withstand financial or other shocks in the future than would have been the case if the Transfer does not take place.

Based on the relevant factors as described in this section, in my opinion the security of benefits for all M&G policyholders will be significantly enhanced by the Transfer.

5.3. Investment strategy

5.3.1. *With-profits policies*

The Transfer will not immediately result in any changes to the investment of assets in the M&G Sub-Fund. I understand that SF plans to carry out a review within one year following the Transfer to assess whether appropriate changes could be made

for the benefit of policyholders in the M&G Sub-Fund, with the results of the review subject to oversight by the Monitoring Committee. The review of SF will be carried out within the context of the M&G Sub-Fund being in a stronger financial position relative to the position of M&G if the Transfer does not take place.

M&G currently operates different asset allocation strategies for conventional and unitised with-profits policies and for the estate (with a separate pool of assets maintained for the International Policies which are denominated in euros rather than sterling). This will continue to be the case following the Transfer.

M&G currently holds investments in derivative assets for the purpose of protecting the solvency position of the company. These investments provide protection for a finite period of time, after which M&G would make a decision on whether to extend the protection taking into account its financial position. I understand that M&G will continue to regularly review its derivative positions in the normal course of events up to the point that the Transfer takes place. Post Transfer, SF intends to adopt a similar approach to M&G in terms of managing the derivatives position. While SF does not currently hold derivatives, I understand that M&G's existing investment advisers and service providers with respect to derivatives will be retained after the Transfer and there is a planned session between the actuarial teams of M&G and SF to facilitate internal knowledge transfer in terms of managing derivatives. Furthermore, a member of the current senior management of SF has prior experience in managing derivatives from his previous employment. It is therefore my opinion that SF will have the necessary expertise to manage these derivatives.

Therefore, in my opinion, with-profits policyholders in the M&G Sub-Fund will not be adversely affected by the Transfer in relation to investment strategy.

5.3.2. Unit-linked policies

Under the terms of the Transfer, the assets and liabilities in respect of each unit-linked fund in M&G will be transferred to a new corresponding unit-linked fund in the SF Main Fund, without any change to the number and value of units.

The new corresponding unit-linked funds will initially be established with the same investment objectives, investment restrictions and investment policies as applied by M&G prior to the Transfer.

In my opinion, transferring unit-linked policyholders will not be adversely affected by the Transfer in relation to investment strategy.

5.3.3. *Non-profit policies*

The Transfer will not have an impact on non-profit policyholders in relation to investment strategy.

5.3.4. *FIA policies*

Under the terms of the Transfer, the FIA policies will be transferred into the M&G Sub-Fund. The unit funds will continue to be fully reinsured with MGMA and therefore, in my opinion, transferring FIA policyholders will not be adversely affected by the Transfer in relation to investment strategy.

5.4. Expenses and charges

5.4.1. *With-profits policies*

The asset shares of M&G's unitised with-profits and FIA policyholders are currently charged defined costs which can be increased to reflect the actual expenses. This will be changed so that following the Transfer the charges can also be decreased to reflect the actual expenses.

For assets shares of M&G's conventional with-profits policies, expense charges are set at levels intended to represent the proportion of total expenses attributable to those policies. Following the Transfer, expense charges to asset shares will be set at defined levels (at levels equivalent to the amounts currently charged) and it will be possible to increase or decrease them in the future to reflect the actual expenses. While the methodology for allocation of expenses to asset shares will change, there will be no immediate significant financial impact for the policyholders as the level of expenses charged remains unchanged over the short term.

Over the longer term, in my opinion, the changes described above would create the conditions for a fair distribution of the benefits of the Transfer across the different groups of with-profits policyholders (i.e. conventional with-profits, unitised with-profits and FIA policies) in the future as a result of the expense allocation methodology being made consistent across each group of policyholders (see section 7.5 for more details).

Furthermore, I have considered the following key aspects of the Transfer in relation to expense and charges for the M&G Sub-Fund at the level of the fund (as opposed to the policy level):

- The M&G Sub-Fund will benefit from lower per policy administration costs compared to the existing arrangements with ServCo

- The M&G Sub-Fund will no longer incur additional overheads related to operating an insurance entity as these costs will be absorbed by the SF Main Fund
- The Transfer will trigger a break fee payable to ServCo but having reviewed materials presented to me, the value of expense savings and elimination of overheads will significantly exceed the cost of the break fee in my opinion.
- Although the Transfer will also trigger a £8m payment to ICE to terminate the Reinsurance Intermediation Agreement, in my opinion this payment has, at worst, a neutral economic impact to M&G as it removes a contingent liability which would start to increase after 31st May 2015 and is very likely to be payable at some future point in any case.
- M&G would incur significant project costs in relation to the Transfer, although this would have been the case in the event of a transfer to any other insurer or friendly society.
- If M&G does not complete a transfer before 1st January 2016, it would be necessary to implement Solvency 2 as a standalone entity. M&G has indicated to me that in the absence of the Transfer, it expects to incur Solvency 2 implementation costs in the range of £1m to £2m. Based on my experience within the UK insurance industry I consider this to be a not unreasonable estimate, although it is also possible that the eventual Solvency 2 implementation costs could be significantly higher. In contrast, under the terms of the Transfer, none of the costs expected to be incurred by SF in relation to Solvency 2 will be allocated to the M&G Sub-Fund.

Taking into account the points described above, in my opinion, the M&G Sub-Fund will benefit from significant expense savings as a result of the Transfer. While these savings would not be passed immediately to M&G's with-profits policyholders, they would contribute to an improvement in the financial position of the fund, relative to the position if the Transfer does not take place. It is also M&G's and SF's intention that the benefits of the cost savings will be distributed fairly over time once the financial condition of the fund permits such distributions.

5.4.2. Unit-linked policies

I have been informed by M&G and SF that the charges on the relevant M&G unit-linked policies will not be changed as a result of the Transfer, and this is confirmed by the terms of the Scheme, which I have reviewed. Furthermore, under the terms of the Transfer, any reviews of charges on unit-linked policies after the Transfer are subject to the same governance arrangements that are applicable to other policies within the SF Main Fund.

Therefore, in my opinion, unit-linked policyholders will not be adversely affected by the Transfer in relation to expenses and charges.

5.5. Benefit expectations and bonus prospects

The focus of this section is on the benefit expectations and bonus prospects of with-profits and FIA policyholders of M&G.

For the with-profits (excluding FIA) policies, the status quo as specified within the PPFM is as follows:

- M&G uses an “asset share” methodology to determine the starting point for determining the payouts for each with-profits policy, calculated as the accumulation of premiums and investment returns less tax and costs (as described in section 5.4).
- On maturity of conventional with-profits policies, M&G aims to pay out an average of 100% of asset shares and targets payouts within the range of 80% to 120% of asset shares for at least 90% of all maturities. M&G also has a target range of 80% to 120% of asset shares for determining average payouts on surrender.
- On surrender or maturity of unitised with-profits policies, M&G aims to pay out an average of 100% of asset shares and targets payouts within the range of 90% to 110% of asset shares for at least 90% of all maturities.
- M&G awards annual and final bonuses to policies, both of which are determined by reference to asset shares and taking into account the solvency of the fund.
- No other costs or charges are applied to the asset shares

For the FIA policies, the status quo as specified within the PPFM is as follows:

- The annuity payable is initially determined as the lifetime annuity supportable by the assets allocated to the policy (taking into account benefits selected and based on assumptions regarding future life expectancy and investment returns selected by the policyholder) and is reviewed periodically
- Funds are invested in units in internal segregated funds selected by the policyholder and investment returns directly reflect the actual returns on the funds supporting each policy
- Expense charges (as described in section 5.4) are deducted from the funds on a monthly basis
- The payment of the annuity is funded by cancelling units in the policyholder’s funds
- Mortality profit or losses on FIA policies are pooled and shared out across those policies alone
- M&G awards annual bonuses (but no final bonuses) to FIA policies

- The annuity amount is subject to a guaranteed minimum level and a charge is taken to meet the cost of this guarantee

Under the terms of the Transfer, there will be no immediate change in the methodology for determining annuity payments, apart from changes in the allocation of expenses to asset shares for conventional with-profits discussed in 5.4.

However, over time, it is expected that with-profits policyholders will be eligible for benefit enhancements when sufficient surplus capital emerges within the M&G Sub-Fund. The method of distributing any surplus capital will be reviewed by the Monitoring Committee and the existing with-profits governance arrangements within SF, and is subject to appropriate benefit security for all policyholders being retained. In my opinion, such benefit enhancements would be very unlikely to be possible if the Transfer does not take place and M&G remains a standalone entity.

Taking into account the considerations set out above, in my opinion with-profits policyholders in the M&G Sub-Fund will not be adversely affected by the Transfer with respect to benefit expectations and bonus prospects. It is also my understanding and opinion that the benefits under Staff Pension Plan would not be affected by the Transfer, because the Pillar 1 and Pillar 2 financial position of the M&G Sub-Fund improves significantly following the Transfer.

5.6. Risk profile and capital management policy

For the purpose of my analysis in this section, I have taken into account the following events which have recently occurred or will occur prior to the Transfer, both of which resulted in significant changes to the risk profile of M&G:

- Reinsurance of Standard and Select annuities with RGA
- The Part VII transfer of the EA policies to MGMA

Both result in significant risk reductions in M&G's business, particularly in relation to longevity risk, interest risk and credit risk. Subsequent to those events, the key risks remaining in M&G's business are equity risk, expense risk and operational risk.

In my opinion, the main impact that the Transfer will have on the risk profile of M&G is to provide greater cost certainty for the business and reduce the potential impact of adverse expense stress scenarios as a result of:

- Fixed per policy expense charges guaranteed for the full duration of all policies (compared to a 10 year guarantee currently)

- Elimination of overhead costs and exposure to unexpected project costs (e.g. Solvency 2)

In my opinion, if the Transfer does not take place, M&G would face significant cost uncertainties in the future as a standalone entity.

Apart from the greater cost certainty described above, the other types of risk faced by M&G will not change significantly as a result of the Transfer, nor will the Transfer introduce any significant new risks to the M&G Sub-Fund. It is therefore my opinion that the Transfer will have a positive impact on the risk profile of M&G (and the M&G Sub-Fund after the Transfer).

Following the Transfer, the M&G Sub-Fund's capital management policy will be determined in line with the provisions of the Fundamentals of Financial Management ("FFM"), subject to oversight and monitoring by the Monitoring Committee. In addition:

- The Transfer provides for capital support to be provided by the SF Main Fund if required, which lends additional flexibility for the future management of the M&G Sub-Fund
- In the proposed new PPFM, explicit references to possible additional distribution of the estate (or excess capital) in the future have been added

Apart from the above which I view to be reasonable and appropriate, there are no other planned changes to the capital management policy of the M&G business as a result of the Transfer. Furthermore, it is my opinion that the security in place for policyholders in the event of reinsurer insolvency is, at worst, unchanged as a result of the Transfer.

5.7. SF run-off scenario

It is possible that in the future, the SF Main Fund may stop writing new business and enter into run-off. Under such a scenario, the business of SF may eventually be transferred to another insurer, although I consider that it is extremely unlikely that SF opts to transfer the M&G Sub-Fund (or any of its other sub-funds) in isolation to another insurer as I do not believe that it would be either commercially or operationally attractive to do so. In the event that all (or parts) of SF's business was transferred to another insurer in the future, it would be subject to similar regulatory and legal processes that apply to the Transfer.

5.8. Conclusions

Based on the analysis set out in this section, I have concluded that:

- The security of benefits for all M&G policyholders will be significantly enhanced by the Transfer.
- The level of premiums payable for all policies will not be affected by the Transfer.
- Due to the contractual nature of non-profit business, the benefits of non-profit policies will not be affected by the Transfer.
- The with-profits policyholders in the M&G Sub-Fund and the transferring unit-linked and FIA policyholders will not be adversely affected by the Transfer in relation to investment strategy.
- Furthermore, the with-profits policyholders in the M&G Sub-Fund will benefit from significant expense savings as a result of the Transfer and it is SF's intention that the benefits of the cost savings will be distributed to eligible policyholders in the M&G Sub-Fund fairly over time once the financial condition of the fund permits such distributions. Unit-linked policyholders will not be adversely affected by the Transfer in relation to expenses and charges.
- With-profits policyholders in the M&G Sub-Fund will not be adversely affected by the Transfer with respect to benefit expectations and bonus prospects.
- The Transfer will have a positive impact on the risk profile of M&G (and the M&G Sub-Fund after the Transfer). With the exception of the provision of capital support by the SF Main Fund and the possible additional distribution of the estate in the future, there are no planned changes to the capital management policy of the M&G business as a result of the transfer.

6. Financial effect of the Transfer on SF policyholders

In this section, I have considered the financial effect of the Transfer on the following groups of SF policyholders:

- With-profits policyholders in the SF Main Fund
- With-profits policyholders in each of the sub-funds
- All non-profit policyholders
- All unit-linked policyholders

I have assessed the impact of the Transfer on all groups of policyholders in terms of security of benefits. I have also assessed how the Transfer would affect the investment strategy and expense charges with respect to each separate group of with-profits and all unit-linked policyholders. Finally, I have considered the implications of the Transfer for the benefit expectations and bonus prospects for each separate group of with-profits policyholders.

The level of premiums payable for all policies will not be affected by the Transfer. Due to the contractual nature of non-profit business, the benefits of non-profit policies will not be affected by the Transfer.

6.1. Security of benefits

Under the provisions of the FFM, SF will manage the M&G Sub-Fund such that its assets are able to cover its liabilities and its capital and solvency requirements. However, it is possible that during periods of adverse financial or other conditions, temporary capital support will be available to the M&G Sub-Fund under the terms of the Transfer:

- In the event that there are sufficient assets within the M&G Sub-Fund to cover its liabilities, the capital support would not involve funds being transferred into the sub-fund. While the capital requirements associated with the business in the sub-fund would be made available from the SF Main Fund, the sub-fund would not have an exclusive right to any specific assets. Assets equal to the capital requirements would therefore not be transferred but would be supported by the SF Main Fund.
- In the event that there are insufficient assets within the M&G Sub-Fund to cover its liabilities, SF will transfer assets into the sub-fund under a contingent arrangement, of value equal to the shortfall relative to liabilities.

The charge for this capital support to the M&G Sub-Fund will be 4% per annum for any amount under £10m and 6% per annum for any amount over £10m, above the base rate of Barclays Bank plc. I consider this to be a fair and commercial rate of return for the capital provided.

As shown in section 4, the M&G Sub-Fund is expected to be comfortably solvent on the Pillar 1 basis. I have reviewed the analysis provided by M&G and SF which shows that the M&G Sub-Fund will also be comfortably solvent on the Pillar 2 basis as well under Solvency 2. Furthermore, additional management actions can be taken to improve its solvency position if required (for example, there is scope to reduce the proportion of assets invested in equities from current levels which would reduce capital requirements whilst adhering to the PPFM). Therefore as the M&G Sub-Fund is comfortably solvent on all regulatory bases I consider the likelihood of it requiring additional capital support to be extremely unlikely.

It should also be noted that the SF Main Fund (as shown in section 4) is in a strong financial position with Pillar 1 Free Assets of £77.3m as at 31st December 2013 (and expected to increase as a result of the Transfer). In my opinion, in the unlikely event that the M&G Sub-Fund requires capital support, the SF Main Fund has sufficient financial capacity to provide the required support without adversely affecting the security of the policyholders in the fund.

SF intends to perform the ICA for the M&G Sub-Fund using its existing methodology for the SF Main Fund and other sub-funds. SF has performed an analysis of the post Transfer Pillar 2 solvency position of the M&G Sub-Fund based on SF's ICA basis and found that the sub-fund's Pillar 2 solvency position will not be materially different as a result of the change in methodology.

As the assets and liabilities of the Scottish Legal, Rational Shelley and LANMAS Sub-Funds are ring-fenced, the security of benefits for policies in those funds will be not be directly affected by the Transfer. To the extent that the sub-funds potentially have access to capital support from the SF Main Fund, the Transfer could in theory result in a reduction in the strength of that capital support. However, it needs to be taken into account that all the sub-funds are comfortably solvent on a standalone basis (as can be evidenced by high solvency ratios shown in section 4). Furthermore, as discussed above, in my opinion the SF Main Fund has sufficient financial capacity to provide any required support to the M&G Sub-Fund without adversely affecting the security of the policyholders in the SF Main Fund.

Taking into account the considerations set out above, in my opinion the Transfer will not have an adverse effect on the security of benefits of current SF policyholders in the SF Main Fund or any of the sub-funds.

6.2. Expenses and charges

The expense charges applicable to the Scottish Legal, Rational Shelley and LANMAS sub-funds and associated with-profits asset shares are fixed. Therefore, the Transfer will have no impact on expenses and charges with respect to with-profits policyholders in the each of the existing sub-funds operated by SF.

With-profits policyholders in the SF Main Fund are charged a fair share of SF's overall expenses. As discussed in section 3, SF expects the Transfer to result in improvements in the economies of scale. Consequently, with-profits policyholders in the SF Main Fund may benefit from reduced expense charges to their asset shares. SF expects the reduction in expense charges as a result of the economies of scale to be small.

Taking into account the considerations as set out above, in my opinion the Transfer is unlikely to have a material impact on expense charges for with-profits policyholders in the SF Main Fund relative to the scenario in absence of the Transfer.

6.3. Investment strategy

The Transfer will not result in any changes to the investment strategy of assets invested on behalf of the current SF with-profits, unit-linked and non-profit policyholders.

6.4. Benefit expectations and bonus prospects

The Transfer will not result in any changes to the benefit expectations and bonus prospects of the with-profits policyholders of SF in so far as they are related to the respective asset shares of the policies in question.

In addition, the Transfer is expected to have the following impact on the Peak 2 Available Capital of the SF Main Fund (which can also be considered as the working capital of the fund):

- A net neutral effect from the transfer of assets and liabilities of the unit-linked and term assurance business to the SF Main Fund
- Reduction of £10m resulting from the payment into the M&G Sub-Fund
- Increase due to positive differences between the expenses charged to the M&G Sub-Fund and the expected costs to SF of administering the transferring policies

Due to these factors, the Transfer would have resulted in a £10.3m increase in the Peak 2 Available Capital of the SF Main Fund as at 31st December 2013 (as shown in section 4.2). At present, the expected benefits described above are attributable to

the working capital of the SF Main Fund and do not directly affect the benefit expectations and bonus prospects of with-profits policyholders in the SF Main Fund.

As part of SF's due diligence in relation to the Transfer, it considered the potential impact of the following scenarios on the value of the Transfer to SF:

- Lapse rates increasing by 50%
- Expenses increasing by 25%
- Annuitant mortality rates reducing by 10%

I have reviewed these scenarios and consider them to be reasonable. Under all the scenarios tested, the financial impact was less than £2m and therefore small relative to the increase in the Peak 2 Available Capital that would have resulted as described above.

In addition, I understand that SF is currently in the process of formalising a policy such that the profits emerging from sub-funds (and profits emerging from subsidiaries and non-profits business within the SF Main Fund) will be determined each year and will be presented to the With-Profits Actuary so that they can determine how much of this should be distributed through bonuses. The formalisation of the policy is expected to be in place for the end of 2014.

Taking into account these considerations, in my opinion the Transfer will not have an adverse effect on the benefits expectations and bonus prospects of current SF with-profits policyholders.

6.5. Risk profile and capital management policy

The status quo with respect to SF's risk profile is as follows:

- SF currently faces a broad mix of different risk types (with no single dominant type of risk), including:
 - Equity risk
 - Interest risk
 - Operational risk
 - Credit risk
 - Expense risk
 - Lapse risk
- As the primary operating fund of SF, the SF Main Fund also bears the most risks in the business. That said, my analysis of the published Pillar 1 solvency positions (as shown in section 4.2) and additional Pillar 2 and Solvency 2 data

provided to me indicates that the SF Main Fund was strongly capitalised as at 31st December 2013.

- Each of SF's sub-funds is expected to be self-sufficient, which means that in the normal course of events the sub-fund is expected to hold meet its capital requirements from capital resources within the sub-fund. My analysis of the published Pillar 1 solvency positions (as shown in section 4.2) and additional Pillar 2 and Solvency 2 data provided to me indicates that all the sub-funds were also strongly capitalised as at 31st December 2013.

Following the Transfer:

- The unit-linked and term assurance business of M&G will be transferred to the SF Main Fund. Although this would involve around £400m of assets and results in a substantial increase in the size of the SF Main Fund, it does not significantly alter the risk profile of the fund. This is because the nature of unit-linked business (with investment risks mostly passed on to policyholders) means that the risk capital associated with the business is comparatively small. The term assurance business will give rise to increases in mortality risk exposure, but this is also minor in the context of the fund as a whole.
- Under the terms of the Transfer, the M&G Sub-Fund is intended to be managed as a self-sufficient sub-fund of SF. However, there are provisions for the SF Main Fund to provide capital support to the M&G Sub-Fund if required. Although the capital support will attract a reasonable return, there remains a risk that any capital provided by the SF Main Fund could become permanently trapped in the M&G Sub-Fund (i.e. a "burn through" risk).
- My review has indicated that the risk profile of the underlying business in the M&G Sub-Fund is not dissimilar to risks faced by the SF Main Fund and other sub-funds, and therefore does not materially expose SF to new types of risk or increase the level of SF's exposure to existing risks.
- From the perspective of the M&G Sub-Fund, it would remain exposed to risks of a systemic nature (which would similarly affect the SF Main Fund) but no more so than the levels it would be exposed to in the absence of the Transfer.
- I have also taken into account the underlying risk exposures arising from the liabilities relating to the Staff Pension Plan as these can be potentially significant and those liabilities give rise to risk exposures which are similar to annuities. It is therefore possible that the Staff Pension Plan could be a significant source of "burn through" risk for the SF Main Fund. In this regard, I have made the following observations:
 - The Staff Pension Plan is now closed to future new accrual and therefore no longer accumulating service related increases to liabilities

- Taking into account the £9m contribution which is expected to be completed by the end of 2014, the plan would have been fully funded on a “statutory funding basis” as at 31st December 2013
- I have relied on the reports produced by the Scheme Actuary of the Staff Pension Plan as at 31st December 2012 and 31st December 2013, and in addition I have performed a high level assessment of the underlying assumptions adopted for the valuations and found them to be not unreasonable (in particular, the longevity assumptions are not dissimilar to those typically adopted by insurance companies for Pillar 1 annuity liabilities).
- Another key assumption underlying the valuation as at 31st December 2013 was the discount rate used. The statutory valuation as at 31st December 2013 was based on a discount rate of 4.6% per annum (based on gilt yields plus 1.15% per annum) which is not unreasonable for a pension scheme valuation on a “statutory funding basis”.
- It should also be noted that the impact on the Staff Pension Plan of deteriorating financial conditions have been allowed for in SF’s analysis of the financial impact of the Transfer under both Pillar 2 and Solvency 2 bases (as described in sections 4.3 and 4.4), as the market risk capital associated with the Staff Pension Plan has been included in the post Transfer financial position of the M&G Sub-Fund.
- In order to aid my thinking further, I have derived an estimate of theoretical “buyout cost” (i.e. the cost of transferring the liabilities of the Staff Pension Plan to another insurance company) to assess the potential financial implications under such a scenario. While I understand there are no immediate plans by SF and M&G to implement a “buyout” of the plan in the near future, this provides a useful market based benchmark for the potential cost of de-risking the plan.
- In his reports, the Staff Pension Plan’s Scheme Actuary considered discounting the liabilities at gilt yields less 0.5% per annum to be a reasonable basis for estimating “buyout costs”. Based on my understanding of the current bulk annuity market and discussions with other pension actuaries, I believe that this approach is at the conservative end of the range of common practices adopted by pension schemes when estimating “buyout costs”. In my view, basing the estimate on discounting the liabilities at gilt yields (with no adjustment) provides a more realistic picture of potential “buyout costs”.
- Using sensitivity analysis disclosed in the relevant pension scheme valuation report, I estimate the potential “buyout cost” (based on gilt yields with no adjustment) to be in the range £20m to £25m. I have also factored into my consideration that in a buyout scenario, there would be a significant reduction in the associated Pillar 2 and Solvency 2 risk capital

(which I estimate would offset at least 50% of the impact of the buyout cost on the Pillar 2 and Solvency 2 solvency positions).

- Although a “buyout” would have a significant effect on the financial position of the M&G Sub-Fund, the sub-fund would remain comfortably solvent on Pillar 1, Pillar 2 and Solvency 2 bases
- It is therefore my opinion that pension scheme liabilities are manageable and do not give rise to material additional risk of “burn through” in relation to the M&G Sub-Fund
- In my discussions with SF, it has indicated that when considering risk appetite, it takes into account (inter alia) the risks to which the business is exposed and the regulatory requirements. The Actuarial Function Holder has expressed an opinion that the Transfer does not change the risks to which SF is exposed, and that there is no consequential requirement to revise the risk appetite. I fully agree with this view.

In relation to SF’s capital management policy:

- SF manages itself to internal tolerances around capital adequacy, primarily relating to the capital coverage on a Pillar 2 basis. These are outlined in the risk appetite within the Risk Management Framework, which feeds into its Own Risk Solvency Assessment.
- Quantitative analysis undertaken by SF (which I have reviewed and consider to be reasonable and appropriate) shows that the Transfer will not result in any significant change to capital coverage on a Pillar 2 basis, either to the SF Main Fund or to SF as a whole. It also shows the Transfer would not result in the risk tolerance relating to the capital coverage to be breached (or be in danger of being breached).
- Furthermore, the Actuarial Function Holder of SF has stated in his report that he does not expect the internal tolerances currently adopted by SF to change as a result of the Transfer
- It was also noted in the SF Actuarial Function Holder’s report that there remains a degree of uncertainty as to how capital management will operate in a Solvency 2 environment with regards to “ring-fencing” of funds. However, he has indicated that even under a scenario where it is necessary to demonstrate capital adequacy on a “ring-fenced” basis for each of the sub-funds, the Transfer would not significantly affect the capital management of SF as all the sub-funds would remain self-sufficient under Solvency 2 on a “ring-fenced” basis. I have reviewed the underlying analysis supporting this opinion and fully agree with those conclusions. It is therefore my opinion that the impact of the Transfer on SF’s capital management policy and risk profile is materially unaffected by the outcome of the final Solvency 2 rules “ring-fencing”.

Taking into account the considerations set out in this section, in my opinion the Transfer will not have an adverse effect on the risk profile or capital management policy in the SF Main Fund or any of the sub-funds.

7. Administration and governance

7.1. Overview

In this section, I consider the administrative and governance arrangements that will be in place following the Transfer. My review focuses on the assessment of whether adequate provisions have been made under the terms of the Transfer to mitigate the risk of deterioration in standards of service experienced by M&G policyholders following the Transfer, adequate safeguards are in place to ensure that the Transfer operates as presented and whether adequate safeguards are in place against a subsequent change of approach that could act to the detriment of any policyholders.

7.2. Service levels

Following the Transfer, the administration of all the policies within the M&G Sub-Fund (currently undertaken by ServCo) will be transferred to SF. There is therefore a risk that both M&G and current SF policyholders could experience adverse changes to the standards of service following the Transfer as:

- The in-house SF administration team will be, at least initially, relatively inexperienced in administering M&G policies and have limited knowledge of the M&G products (in particular the FIA policies)
- Given the fixed cost agreement, SF may seek to minimise the costs associated with the administration of M&G policies which could also have a detrimental effect on the servicing of all policies

I have reviewed the service level standards proposed by SF for the administration of M&G policies post Transfer and have found that where the standards are comparable, they are at least equal to those currently in place with ServCo and in many cases significantly higher.

I also understand that SF has a general policy to apply the same service level standards for all existing policies, and if service level standards were higher for a group of policies following an acquisition, it would also be applied to all other policies.

Furthermore, the Monitoring Committee has the responsibility to monitor the fair treatment of policyholders in the M&G Sub-Fund, including compliance with applicable PRA rules and guidance on treating customers fairly. I have interpreted this to include maintaining a fair level of service standards for the policyholders.

As part of my investigations into the quality of SF's service capabilities and its ability to manage the transition as part of the Transfer, I have conducted an interview with the Head of Client Services at SF, and found that:

- SF currently has over 1.1m policyholders covering around 150 product variations
- The Transfer will involve SF taking over the administration of around 70,000 to 80,000 additional policies with similar product features to SF's existing portfolio with the possible exception of FIA business
- With respect to FIA business, the key features of the product and required administrative processes are substantially similar to SF's existing requirements in relation to other products in its portfolio including:
 - Multiple investment options
 - Regular income payments
 - Range of permitted income levels
 - Payments subject to PAYE
 - Death processes
 - Regular statements
 - Unit deductions
 - Bonus allocation
 - Regular financial reviews
 - Commission payments to IFAs
- SF has already conducted extensive operational due diligence on M&G's product suite (and in particular the FIA business) and a detailed IT and operational project plan is currently in place.
- Over the past 12 months, SF has comfortably exceeded its target service level standards
- SF uses Talisman⁸, which is the same operating platform currently used for administering the majority of M&G policies
- SF has successfully implemented past transfers (as detailed in section 3.2) including the migration of Scottish Legal Life policies onto Talisman, covering over 500,000 policies
- SF has an extensive track record of product development (either on its own or in partnership with third parties) with typically lead time from product inception to product launches of 6 months (including with-profits business)
- A key area of SF's differentiation in administrative capabilities lies in the development and continued use of automated workflow systems. I understand that SF plans to configure its automated workflow systems for the FIA business as part of the IT and operational project plan.

⁸ An administration software system owned by Bravura Solutions

- SF receives positive customer feedback on its services, as illustrated in ABI's customer benchmarking survey in 2012 which found that 92% of SF's surveyed customers responded that it "gives clear information and good service" while 93% responded that it "is easy to do business with"

In my opinion, adequate provisions have been made under the terms of the Transfer to mitigate the risk of deterioration in standards of service experienced by both M&G and existing SF policyholders following the Transfer. It is also my opinion that SF operates to a high level of service standard and has the necessary experience and ability to manage the transition of M&G policies (including FIA policies) into SF.

I understand that SF intends to recruit 6 to 7 additional staff to its Client Services team (with current full time staff of 38) following the Transfer. In my opinion, taking into account factors described in this section, SF will have sufficient resources and IT capability to apply the service level it proposes for the Transfer.

7.3. Management of FIA policies

The FIA is not a common product in the UK life insurance sector and it is therefore important to assess whether SF has a strong understanding of how FIA policies work, the risks associated with the product and that it can adequately administer those policies. Further details of FIA policies can be found in Appendix E.

To aid my assessment, I conducted a series of meetings with the management of SF to discuss their preparations for managing the product post Transfer as well as reviewing the materials provided to me. I made the following observations:

- As discussed in section 7.2, SF has already conducted extensive operational due diligence on M&G's product suite (in particular the FIA business) and a detailed IT and operational project plan is in place. In my opinion, SF has a strong understanding of the operational aspects of the FIA policies.
- At the time of my writing of this report, M&G and SF are already in advanced stage of information sharing in relation to the actuarial and financial aspects of the FIA business. I have also take into account that SF has a long established history of managing with-profits business and therefore will already be familiar with general aspects of the product's with-profits elements. It is therefore my opinion that by the Effective Date, SF will have the necessary understanding and knowledge to manage the product from an actuarial and financial perspective.
- Furthermore, the required administrative processes for the FIA product are substantially similar to SF's existing requirements in relation to other products in its portfolio. I am therefore confident that SF can adequately administer these policies.

Taking into account the considerations set out in this section, in my opinion SF has a strong understanding of how FIA policies work, the risks associated with the product and can adequately administer these policies.

7.4. Fundamentals of Financial Management

The principles governing the future management of the M&G Sub-Fund have been set out in the FFM as part of the terms of the Transfer. The key principles established include:

- The basis for calculating the capital position with respect to the M&G Sub-Fund
- Circumstances and associated terms for the provision of capital support by the SF Main Fund, for example the M&G Sub-Fund will aim to not directly rely on the capital support mechanism so that extra costs are not routinely incurred
- Governance arrangements for review of discretion relating to the charges applied to asset shares or exceptional charges applied to the fund
- Policies on the determination of appropriate management actions for the M&G Sub-Fund, for example its investment strategy
- High level policies in relation to fair distribution of excess capital to eligible policyholders
- The Monitoring Committee to provide both continuity of knowledge of M&G's business, and to support the existing corporate governance arrangements within SF (discussed further in section 7.5)
- Arrangements for the future closure of M&G Sub-Fund (discussed further in section 7.7)

The FFM will also be used to guide future versions of the M&G Sub-Fund's PPFM.

7.5. Principles and Practices of Financial Management ("PPFM")

The PPFM is a document that must be produced for every with-profits fund under the rules and guidance set out in chapter 20 of the Conduct of Business sourcebook ("COBS") of the Regulatory Handbook. Each PPFM provides a comprehensive description of how the relevant with-profits fund is managed, including a statement of the Principles and Practices adopted by the insurer in respect of a wide range of aspects relevant to the management of the fund in question.

I have compared the proposed new PPFM for the M&G Sub-Fund against the current PPFM for M&G's with-profits and FIA policies and the main differences are summarised below:

- Addition of explicit references to possible additional distribution of the estate (or excess capital) in the future
- In the proposed new PPFM, for conventional with-profits policies, expenses charged to asset shares are set at fixed, per policy amounts (equivalent to the amounts currently charged). In the previous PPFM, expense charges for conventional with-profits policies were intended to represent the proportion of total expenses attributable to those policies.

While there is a change in the methodology for expense allocation to asset shares for conventional with-profits policies, in practice it would not result in any significant short term difference in asset shares of those policies. Furthermore, in my opinion, the change would create the conditions for a fair distribution of the benefits of the Transfer across the different groups of with-profits policyholders (i.e. conventional with-profits, unitised with-profits and FIA policies) in the future as a result of the expense allocation methodology being made consistent across each group of policyholders.

Based on my review as set out above, I believe that the proposed new PPFM for the M&G Sub-Fund is reasonable and an accurate reflection of the terms of the Transfer.

7.6. Monitoring Committee

As part of the Transfer, SF will set up a Monitoring Committee, a sub-committee of the SF Board responsible for providing an independent oversight over the management and operations of the M&G Sub-Fund and monitoring adherence to the terms of the Transfer.

The operation of the Monitoring Committee is governed by the terms of reference which were agreed as part of the Transfer. Under those terms of reference, the Monitoring Committee has responsibilities to report to the Board of SF on, inter alia:

- Application of the investment policy applicable to the M&G Sub-Fund
- Whether the charges levied against the M&G Sub-Fund are in accordance with the terms of the Transfer
- The general operation of the M&G Sub-Fund PPFM
- Tax charges to be borne by the M&G Sub-Fund
- Continued appropriateness of the management action policy, risk appetite policy, distribution policy and run-off strategy for the M&G Sub-Fund

The Monitoring Committee will be provided with sufficient resources to undertake its duties and may, on the agreement of the Chairman of the Monitoring Committee

obtain appropriate professional external advice, such cost to be borne by the M&G Sub-Fund. The Monitoring Committee may consult with the With-Profits Actuary or the SF Independent Person concerning any matter falling within its remit.

Furthermore, there is a provision for any member of the Monitoring Committee to notify the regulators of any matter he/she wishes to bring to their attention.

The Monitoring Committee will be in operation for at least three years after the Transfer, following which the Monitoring Committee will be dissolved once it considers that its key role of embedding the business and monitoring consistency with past practice has been completed. There will be five members in the committee with two nominated by M&G and three nominated by SF.

I understand that the Monitoring Committee will be chaired by a Non Executive Director of SF and will have two members appointed by M&G. In my view this will provide a suitable mix of experience and perspective to enable it to carry out its obligations under its Terms of Reference, which I also consider appropriate.

Note that it is not the intention that the Monitoring Committee would replace current governance arrangements; rather that it provides additional protection during the initial period after the Transfer. Post Transfer, SF's existing with-profit advisory arrangement will also cover the business in the M&G Sub-Fund.

In my opinion, the existence of the Monitoring Committee provides significant additional comfort that appropriate governance processes will be in place for the management of policies in the M&G Sub-Fund post Transfer.

7.7. Future closure of the M&G Sub-Fund

Under the terms of the Scheme, the M&G Sub-Fund may be wound up with effect from the earlier of:

- 1st January 2030
- The date on which the number of with-profits policies (including FIA policies) reduces to 8,000 or less
- The date on which the number of FIA policies exceeds 80% of the total number of with-profits policies (including FIA policies)

In the event of one of the above circumstances and provided that the regulator does not object, SF may amalgamate the M&G Sub-Fund into the SF Main Fund in accordance with the principles set out in the M&G Sub-Fund FFM. The remaining capital in the M&G Sub-Fund will be used to enhance the policy benefits of the remaining with-profits policies within the M&G Sub-Fund at that time. As part of this transfer, it is expected that all with-profits policies will be modified so as to remove their right to participate in future surplus – that is, they will benefit from the distribution of the residual estate in the Sub-Fund at the time of integration but will

have no further right to the then existing and future surplus in the SF Main Fund. This modification will be approved by the With-Profits Actuary and notified to the Regulator.

In my opinion, provisions for future closure of the M&G Sub-Fund and the conditions set out under the terms of the Transfer are not unreasonable nor inappropriate.

7.8. PRA and FCA regulations

It is also worthwhile noting that SF is and will continue to be bound by the Regulatory Handbook of regulations in relation to the management of its business. In particular:

- Chapter 20 of COBS sets out additional requirements specific to the conduct of with-profits business. This includes a requirement for SF to *“take reasonable care to ensure that all aspects of its operating practice are fair to the interests of its with-profits policyholders and do not lead to an undisclosed, or otherwise unfair, benefit to shareholders or to other persons with an interest in the with-profits fund”* (COBS20.2.1A)
- Under chapter 4 of SUP, a With-Profits Actuary must be appointed in respect of the M&G Sub-Fund who will be responsible for, inter alia, advising SF on key aspects of the discretion to be exercised affecting with-profits business and producing an annual report to the SF Board on key aspects of the discretion exercised (including the application and compliance with the PPFM)

7.9. Solvency 2 preparations

In this section, I consider the Transfer’s impact on SF’s Solvency 2 preparedness and the adequacy of SF’s resources to facilitate the work needed for Solvency 2 compliance. To aid my assessment, I have reviewed SF’s Solvency 2 implementation plans (and its progress since 2013) and its Own Risk and Solvency Assessment report as at 31 December 2013, in addition to materials specifically related to the Transfer.

I made the following observations:

- SF has already made significant progress in relation to Solvency 2 implementation to date, and in my opinion, is not out of line with its peer group in terms of its level of preparedness for Solvency 2
- SF has explicitly incorporated the Transfer into its Solvency 2 plans, including addition of workstreams to:
 - Assess implications of the Transfer and make relevant changes in relevant workstreams

- Ensure the Solvency 2 plan takes account of business changes arising from the Transfer
 - Assess the impact of any assets transferred from the Transfer in respect of Solvency 2 requirements
- A potential key area of uncertainty in relation to Solvency 2 relates to how capital management will operate in a Solvency 2 environment with regards to “ring-fencing” of funds. However, even under a scenario where it is necessary to demonstrate capital adequacy on a “ring-fenced” basis for each of the sub-funds, all the sub-funds would remain self-sufficient.

Taking into account the considerations set out in this section, in my opinion the Transfer will not adversely impact on SF’s Solvency 2 preparedness and the adequacy of SF’s resources to facilitate the work needed for Solvency 2 compliance.

7.10. Conduct risk

My assessment of conduct risk aspects of the Transfer focussed primarily on the administrative and governance arrangements that will be in place post Transfer and this is discussed in detail in the rest of section 7. Furthermore, I have taken into account the impact of the Transfer on the membership rights of SF and M&G members as well as SF’s and M&G’s communication strategy with respect to the Transfer, which are discussed in detail in section 8.

In addition, I have considered the following relevant elements of “conduct risk” in relation to the Transfer:

- **Available investment options with respect to the FIA policies:** Under the terms of the Transfer, the unit funds of FIA policies will continue to be fully reinsured to MGMA. I understand that the range of funds that FIA policyholders will have access to will not be impacted by the Transfer.
- **Mis-selling:** I am not aware of any significant mis-selling issues currently faced by SF or M&G
- **SF policyholder complaints:** I have reviewed SF’s experience and management processes with respect to policyholder complaints and have noted that:
 - SF receives 35 to 70 complaints per month (average of 49 in 2013). I consider this to be a low number of complaints within the context of around 1.1m policies currently administered by SF.
 - It conducts specialised training for complaints handlers and monthly root cause analyses and feedback in relation to complaints
 - It participates in a peer discussion group on complaint handling

- It participates in industry benchmarking which provides useful comparison for how SF's complaints statistics compare with its peers

Taking into account considerations set out in this section, I am satisfied that there are no material issues relating to "conduct risk" which would adversely affect policyholders of SF and M&G as a result of the Transfer.

7.11. International Policies

The management of M&G's International Policies is subject to "Principles of Financial Management" which was set out in the applicable scheme of transfer when the business was transferred from MGM International Assurance to M&G in 2009. I have reviewed the "Principles of Financial Management" as described above and am satisfied that it does not give rise to any additional governance aspects of managing the International Policies which needs to be taken into account in my review.

7.12. Conclusions

Taking into account the provisions as described in this section and my understanding that the existing governance and administrative arrangements for current SF policyholders will not be significantly affected by the Transfer, in my opinion adequate safeguards are in place to ensure that the interests and rights of the policyholders of M&G and SF will be protected post Transfer.

8. Membership rights and policyholder communications

8.1. Membership rights

All M&G FIA and other with-profits policyholders (other than some pension with-profits policyholders where the Trustee is the member) are currently members of M&G. Non-profit and unit-linked policyholders of M&G do not currently have membership rights. Following the Transfer, M&G members will lose their membership and voting rights in M&G. I understand that membership in M&G does not currently convey material membership benefits in addition to the benefits under the terms of the policies and their respective rights to participate in the surplus of M&G.

As part of the Transfer, all transferring M&G policyholders will become members of SF, with rights prescribed in the Memorandum and Rules of SF in respect of such a member, including the right to vote and be elected as a Delegate in accordance with the Rules. This means that M&G policyholders who are not currently members will benefit from having gained membership rights in SF.

Under the terms of the Transfer, the surplus in the M&G Sub-Fund will be applied over time for the benefit of the with-profits policies in the M&G Sub-Fund. Furthermore, the assets in the M&G Sub-Fund Fund will only be applied in accordance with the terms of the Transfer or distributed to policyholders in the M&G Sub-Fund.

Therefore, in my opinion, there has not been a material loss of membership benefits for the transferring members as a result of the Transfer.

The rights of SF members will not be affected by the Transfer. While there is some dilution of existing SF members' voting rights, I do not consider this to be a material detriment as I estimate that M&G policyholders will only make up around 6%⁹ of the SF membership following the Transfer, and therefore existing SF members will continue to have the majority of votes.

8.2. Communication to policyholders

SUP18.2.42 to SUP18.2.50 sets out the requirements that M&G and SF needs to comply with regarding the communication strategy with respect to the Transfer. In

⁹ Based on the PRA Returns as at 31 December 2013, there were 95,510 policies in M&G (of which 19,645 were EA annuities which were transferred to MGMA in October 2014) and 1,139,702 policies in SF. Assuming that the ratio of policies to members are similar between the two companies, I estimate M&G policyholders will represent $(95,510 - 19,645) / (1,139,702 + 95,510 - 19,645) = 6\%$ of the total SF membership.

this section I summarise those requirements and set out my opinion on whether M&G and SF's plans are fair and not misleading.

The relevant requirements where action is required by SF and/or M&G under SUP18 are summarised below:

- SUP18.2.42 requires notice of the application for the Transfer to be sent to all policyholders of M&G and SF, and to reinsurers whose reinsurance contracts are to be transferred. Both M&G and SF plan to submit an application for a waiver in relation to the requirement (discussed further below).
- SUP18.2.43 requires notice of the application for the Transfer to be published in appropriate newspapers. Both M&G and SF intend to fully comply with this requirement.
- SUP18.2.44 requires advanced regulatory approval of relevant communication materials. M&G and SF intend to fully comply with this requirement.
- SUP18.2.47 requires that for transferring policies written with residents of an EEA State other than the United Kingdom, consent of the host State is obtained. It also advises that consent is obtained from the regulator of the host State to any waiver of publication. I understand that M&G intends to apply for the relevant waivers, but in the event that the waivers are not obtained, the relevant policies will be excluded from the Transfer (see section 9.2 for further details).
- SUP18.2.48 sets out various requirements relating to the form and content of communication materials. M&G and SF intend to fully comply with this requirement. I have reviewed the draft communication materials to M&G's members and policyholders with respect to the Transfer and consider their contents to be reasonable and appropriate. I have also reviewed the draft communication materials to SF's Delegates with respect to the Transfer and consider their contents to be reasonable and appropriate. Furthermore, my summary of this Report will be included in the statement to policyholders in accordance with the requirements. Copies of this report will be made available to the policyholders of SF and M&G upon request and will be available on the organisations' websites.
- SUP18.2.49 sets out additional requirements relevant to SF in accordance with the Friendly Societies Act 1992. SF intends to fully comply with those requirements.
- SUP18.2.50 requires that regulators are given the opportunity to comment on materials referred to in SUP18.2.48. M&G and SF intend to fully comply with this requirement.

In relation to SUP18.2.42, M&G intends to submit an application for a waiver from writing to policyholders if the address details that it holds are already recorded as "gone away". M&G's believes that it would be sensible to send material to a policyholder at an address that it already records as incorrect. Taking into account

M&G's latest internal "gone away" report and policy, I consider this application to be reasonable and appropriate.

Also in relation to SUP18.2.42, SF intends to submit an application for a waiver in relation to the requirement to write to each individual policyholder, on the basis that appropriate and detailed written communication will be provided to Delegates, who represent the interests of all policyholders. When considering whether the application is reasonable and appropriate, I have paid due regard to the following factors which was outlined in the Court judgement in the case of Aviva International Insurance Limited [2011] EWHC 1901 (Ch) as being an appropriate list of criteria to take into account:

- The impossibility of contacting policyholders
- The practicality of contacting policyholders
- The utility of contacting policyholders
- The availability of other information channels through which notice of the application can be made available
- The proportionality of strict compliance
- The impact of collateral commercial concerns
- The object of the Transfer and its likely impact upon policyholders

I have not treated the factors as formal requirements, nor have I attached equal weighting to each factor, but instead have sought to arrive at a balanced view taking into account the set of factors listed. Furthermore, I do not believe that there are any other factors not listed that I consider relevant to my assessment. In my opinion:

- Whilst it is not impossible for SF to write to every policyholder, to do so would involve a high level of incremental costs (estimated by SF to be £400,000). In addition, there are practical issues around being able to identify certain types of policyholder (as defined for regulatory purposes) and to ensure that they receive the required notification (e.g., where a current policyholder address is not available)
- The Delegate system is a well-established, tried and tested system of governance within SF (and more generally within the Friendly Society sector)
- The powers and responsibilities of Delegates to represent the interests of the membership are enshrined in the Memorandum and Rules of SF
- I understand that SF intends to dedicate a section of its website to the Transfer. This would provide an accessible channel of information which is available to interested SF policyholders to obtain further details regarding the Transfer. Furthermore, in compliance with SUP18.2.43, notice of the application for the Transfer will be published in appropriate newspapers.

- I have also taken into account my opinion that the Transfer does not adversely affect SF policyholders (as discussed in section 6).
- Furthermore, I am not aware of any collateral commercial concerns that should be taken into account in my considerations

It is therefore my view that SF's rationale for the waiver application is sound and appropriate.

I further note that any affected policyholder or reinsurer has the right to raise their objections to the Court. Communication materials for M&G policyholders clearly sets out those rights and the process by which policyholders can make their representations. In addition to notifying all policyholders, M&G also intends to notify all beneficiaries of pension contracts under trust where M&G is the trustee. I will consider any objections made in advance of the Court hearing and where appropriate will report on those objections in a supplementary report.

Taking into account the points set out in this section, it is my opinion that M&G's and SF's planned communications strategy is reasonable, fair and not misleading.

9. Other considerations

9.1. Impact of the Transfer on M&G's reinsurance counterparties

I have reviewed the potential impact of the Transfer on M&G's current reinsurance counterparties (as described in section 3.4) and in my opinion, the Transfer would not have any effect on those reinsurance counterparties.

9.2. Policies written in an EEA State other than the United Kingdom

The Transfer is intended to include all existing M&G policies being transferred to SF. However, it is possible that for policies written with residents of an EEA State other than the United Kingdom (such as the International Policies), the Court is unable to effect the transfer before the Effective Date. Under those circumstances, each policy in question would be classified as an "Excluded Policy" for the purposes of the Transfer and would not transfer to SF but instead remain with M&G. However, the liabilities of Excluded Policies would be fully reassured with SF so as to achieve a similar economic effect as if the Transfer included those policies, until formal consent is subsequently obtained for their transfer to SF. Under such a scenario, M&G will remain a fully capitalised insurance entity up to point that consent is obtained and SF remains fully committed to paying the contractual benefits via the reinsurance treaty. I consider these to be sufficient safeguards to protect the interests of Excluded Policies.

With effect from the Effective Date, SF would also have formal responsibility for the administration of Excluded Policies.

I understand that M&G does currently not expect there to be any Excluded Policies.

9.3. Tax

Under the terms of the Transfer, the M&G Sub-Fund will be taxed as if it were a stand-alone mutual life insurance entity with the M&G Sub-Fund as its sole business. Any benefits arising from tax synergies with other funds held of SF will be shared equally between SF and the M&G Sub-Fund (subject to review by the With-Profits Actuary and the Monitoring Committee).

I have been provided a copy of the tax advice obtained by SF which concluded that the £10m contribution from SF Main Fund into the M&G Sub-Fund is not expected to give rise to significant tax exposure.

Furthermore, under the Implementation Agreement, both M&G and SF will obtain as soon as reasonably practicable all necessary tax clearances from HM Revenue & Customs (“HMRC”).

Taking into account the considerations as set out above, I am satisfied that the Transfer is not expected to have any significant adverse tax impact on the policyholders of SF and M&G, and that no changes are expected to the tax status of M&G policies as a result of the Transfer.

9.4. Financial Services Compensation Scheme and Financial Ombudsman Service

I have no reason to believe that the Transfer will affect the rights of M&G’s or SF’s policyholders to access the Financial Services Compensation Scheme or Financial Ombudsman Service.

Appendix A. Guidance for the Independent Expert

The following excerpts from SUP of the Regulatory Handbook set out the relevant guidance applicable to the role of Independent Expert. References to the relevant sections of the Report are included in italics:

18.2.31

Under section 109 of the Act, a scheme report must accompany an application to the court to approve an insurance business transfer scheme. This report must be made in a form approved by the appropriate regulator. The appropriate regulator would generally expect a scheme report to contain at least the information specified in SUP 18.2.33 G before giving its approval.

Report reference: N/A

18.2.31a

When the appropriate regulator has approved the form of a scheme report, the scheme promoter may expect to receive written confirmation to that effect from that regulator

Report reference: N/A

18.2.32

There may be matters relating to the scheme or the parties to the transfer that the regulators wish to draw to the attention of the independent expert. The regulators may also wish the report to address particular issues. The independent expert should therefore contact the regulators at an early stage to establish whether there are such matters or issues. The independent expert should form his own opinion on such issues, which may differ from the opinion of the regulators.

Report reference: Section N/A

18.2.33

The scheme report should comply with the applicable rules on expert evidence and contain the following information:

- (1) who appointed the independent expert and who is bearing the costs of that appointment;
- (2) confirmation that the independent expert has been approved or nominated by the appropriate regulator;
- (3) a statement of independent expert's professional qualifications and (where appropriate) descriptions of the experience that fits him for the

role;

- (4) whether the independent expert has, or has had, direct or indirect interest in any of the parties which might be thought to influence his independence, and details of any such interest;
- (5) the scope of the report;
- (6) the purpose of the scheme;
- (7) a summary of the terms of the scheme in so far as they are relevant to the report;
- (8) what documents, reports and other material information the independent expert has considered in preparing his report and whether any information that he requested has not been provided;
- (9) the extent to which the independent expert has relied on:
 - (a) information provided by others; and
 - (b) the judgment of others;
- (10) the people on whom the independent expert has relied and why, in his opinion, such reliance is reasonable;
- (11) his opinion of the likely effects of the scheme on policyholders (this term is defined to include persons with certain rights and contingent rights under the policies), distinguishing between:
 - (a) transferring policyholders;
 - (b) policyholders of the transferor whose contracts will not be transferred;
and
 - (c) policyholders of the transferee;
- (11a) his opinion on the likely effects of the scheme on any reinsurer of a transferor, any of whose contracts of reinsurance are to be transferred by the scheme
- (12) what matters (if any) that the independent expert has not taken into account or evaluated in the report that might, in his opinion, be relevant to policyholders' consideration of the scheme; and

- (13) for each opinion that the independent expert expresses in the report, an outline of his reasons.

Report reference: Section 1.1, 1.3, 1.5, 2.1, Section 3.3, Section 5, Section 6, Section 8.1, Appendix B & C

18.2.34

The purpose of the scheme report is to inform the court and the independent expert therefore has a duty to the court. However reliance will also be placed on it by policyholders, by reinsurers, by others affected by the scheme and by the regulators. The amount of detail that it is appropriate to include will depend on the complexity of the scheme, the materiality of the details themselves and the circumstances.

Report reference: N/A

18.2.35

The summary of the terms of the scheme should include:

- (1) a description of any reinsurance arrangements that it is proposed should pass to the transferee under the scheme; and
- (2) a description of any guarantees or additional reinsurance that will cover the transferred business or the business of the transferor that will not be transferred.

Report reference: Section 3.4

18.2.36

The independent expert's opinion of the likely effects of the scheme on policyholders should:

- (1) include a comparison of the likely effects if it is or is not implemented;
- (2) state whether he considered alternative arrangements and, if so, what;
- (3) where different groups of policyholders are likely to be affected differently by the scheme, include comment on those differences he considers may be material to the policyholders; and
- (4) include his views on:
 - (a) the effect of the scheme on the security of policyholders' contractual rights, including the likelihood and potential effects of the insolvency of

the insurer;

(b) the likely effects of the scheme on matters such as investment management, new business strategy, administration, expense levels and valuation bases in so far as they may affect:

(i) the security of policyholders' contractual rights;

(ii) levels of service provided to policyholders; or

(iii) for long-term insurance business, the reasonable expectations of policyholders; and

(c) the cost and tax effects of the scheme, in so far as they may affect the security of policyholders' contractual rights, or for long-term insurance business, their reasonable expectations.

Report reference: Section 1.3, Section 3.3, Section 5, Section 6, Section 7.2, Section 8.1, 8.2, 9.3

18.2.37

The independent expert is not expected to comment on the likely effects on new policyholders, that is, those whose contracts are entered into after the effective date of the transfer.

Report reference: N/A

18.2.38

For any mutual company involved in the scheme, the report should:

- (1) describe the effect of the scheme on the proprietary rights of members of the company, including the significance of any loss or dilution of the rights of those members to secure or prevent further changes which could affect their entitlements as policyholders;
- (2) state whether, and to what extent, members will receive compensation under the scheme for any diminution of proprietary rights; and
- (3) comment on the appropriateness of any compensation, paying particular attention to any differences in treatment between members with voting rights and those without.

Report reference: Section 8.1

18.2.39

For a scheme involving long-term insurance business, the report should:

- (1) describe the effect of the scheme on the nature and value of any rights of policyholders to participate in profits;
- (2) if any such rights will be diluted by the scheme, how any compensation offered to policyholders as a group (such as the injection of funds, allocation of shares, or cash payments) compares with the value of that dilution, and whether the extent and method of its proposed division is equitable as between different classes and generations of policyholders;
- (3) describe the likely effect of the scheme on the approach used to determine:
 - (a) the amounts of any non-guaranteed benefits such as bonuses and surrender values; and
 - (b) the levels of any discretionary charges;
- (4) describe what safeguards are provided by the scheme against a subsequent change of approach to these matters that could act to the detriment of existing policyholders of either firm;
- (5) include the independent expert's overall assessment of the likely effects of the scheme on the reasonable expectations of long-term insurance business policyholders;
- (6) state whether the independent expert is satisfied that for each firm the scheme is equitable to all classes and generations of its policyholders; and
- (7) state whether, in the independent expert's opinion, for each relevant firm the scheme has sufficient safeguards (such as principles of financial management or certification by a with-profits actuary or actuarial function holder) to ensure that the scheme operates as presented.

Report reference: Section 3.4, Section 5, Section 6, Section 7.2, 7.3, 7.4, 7.5, 7.12

18.2.40

Where the transfer forms part of a wider chain of events or corporate restructuring, it may not be appropriate to consider the transfer in isolation and the independent expert should seek sufficient explanations on corporate plans to enable him to understand the wider picture. Likewise he will need information on the operational plans of the transferee and, if only part of the business of the transferor is transferred, of the transferor. These will need to have sufficient detail to allow him to understand in broad terms how the business will be run.

Report reference: Section 3.1, Section 7

18.2.41

A transfer may provide for benefits to be reduced for some or all of the policies being transferred. This might happen if the transferor is in financial difficulties. If there is such a proposal, the independent expert should report on what reductions he considers ought to be made, unless either:

- (1) the information required is not available and will not become available in time for his report, for instance it might depend on future events; or
- (2) otherwise, he is unable to report on this aspect in the time available.

Under such circumstances, the transfer might be urgent and it might be appropriate for the reduction in benefits to take place after the event, by means of an order under section 112 of the Act. Each regulator would wish to consider any such reduction against its statutory objectives and section 113 of the Act allows the court, on the application of either regulator to appoint an independent actuary to report on any such post-transfer reduction in benefits.

Report reference: N/A

Appendix B. Terms of reference

The role of the Independent Expert is to prepare a report for Marine and General Mutual Life Assurance Society Limited (“M&G”), Scottish Friendly Assurance Society Limited (“Scottish Friendly”) and the Prudential Regulation Authority (“PRA”) that opines on the fairness and reasonableness of the prospective Transfer of Engagements (“Transfer”) from the point of view of both the policyholders of M&G and Scottish Friendly, where applicable.

The Independent Expert will consider the following matters in respect of the Transfer:

- a) the impact of the Transfer on the security of policyholder benefits, for different groups and generations, before and after the Transfer including quality of allocated assets/capital backing each sub-fund and whether this is reasonable and fair;
- b) the impact of the Transfer on the benefit expectations for different groups and generations of policyholders, before and after the Transfer;
- c) the impact of the Transfer on costs and expenses to be borne by policyholders after the Transfer;
- d) the financial position pre and post Transfer under Pillar 1, ICAS and Solvency 2;
- e) how the application of discretion, if any, that is exercised in the management of the transferring policies would be affected;
- f) the change, if any, in the capital management policy of the new M&G Sub-Fund after the Transfer;
- g) documents which have been issued or intend to be issued to the policyholders to explain the Transfer;
- h) the calculations, assumptions and methodology used to arrive at the recommendation of the Transfer against the option of run-off;
- i) an analysis of the risks which have been considered including scenario and general stress testing, and the circumstances which may result in the with-profits policyholders receiving a lower pay-out than they could have received in a run-off scenario;
- j) the reasonableness, or otherwise, of the payments in and out of the new M&G Sub-Fund including the proposed administration and service charges, reinsurance arrangements, and the one off cash contribution to be made by Scottish Friendly;
- k) the treatment of the unit-linked and non-profit policies in respect of security, performance, charges and benefits after the Transfer;

- l) what the likely impact of the Transfer will be on investment strategy and expense levels;
- m) the membership rights of the transferring members;
- n) the impact of the Transfer on the level of service provided to policyholders;
- o) the tax consequences of the Transfer in so far as they affect transferring policies and policyholders;
- p) the impact of the Transfer on the governance arrangements for policyholders, taking into account the establishment of the Monitoring Committee;
- q) any other aspect of the Transfer that the Independent Expert considers should be reviewed or any matters drawn to his attention by the PRA in order to opine on the fairness and reasonableness of the Transfer.

Appendix C. Data

Information provided by M&G

Item	Date received
Articles of Association	9 th Sept 2014
Annual Reports and Accounts (for years 2011 – 2013)	9 th Sept 2014
PRA Returns (for years 2011 – 2013)	8 th Sept 2014
ICA Reports (for years 2012 – 2013)	23 rd Sept 2014
Run-off Plan	23 rd Sept 2014
Statutory Valuation Reports (for years 2011 – 2013)	9 th Sept 2014
Principles and Practices of Financial Management for M&G's with-profits policies	5 th Sept 2014
Marketing literature and policy documents	11 th Sept 2014
Various documents relating to the transaction involving the Enhance Annuities business with TDR Capital in November 2013	9 th Sept 2014
Analysis of impact of proposed transfer on M&G's financial position	9 th Sept 2014
Actuarial Function Holder and With-Profits Actuary Report on proposed transfer to SF	1 st Draft: 3 rd Oct 2014 Final Draft: 22 nd Jan 2015
Tax advice	2 nd Oct 2014
Latest Solvency 2 capital impact assessment (based on draft rules)	23 rd Sept 2014
Relevant correspondence with regulators	23 rd Sept 2014
Policyholder communication materials for Safe Haven	1 st Draft: 24 th Sept 2014 Final Draft: 21 st Jan 2015
Report on "gone away" process	10 th December 2014
Information on miscellaneous reinsurance treaties	8 th December 2014
Note on Staff Pension Plan	4 th December 2014
Note on expenses and charges	4 th December 2014

Information provided by SF

Item	Date received
Memorandum and Rules	8 th Sept 2014
Annual Reports and Accounts (for years 2011 – 2013)	5 th Sept 2014
PRA Returns (for years 2011 – 2013)	5 th Sept 2014
Statutory Valuation Reports, including the ICA (for years 2011 – 2013)	8 th Sept 2014
Principles and Practices of Financial Management for all the relevant groups of with-profits policies	5 th Sept 2014
Solvency 2 plans	8 th Sept 2014
Materials relating to SF's administrative capabilities	11 th Sept 2014
Policy documents	5 th Sept 2014
Corporate history and details of past transfers	5 th Sept 2014
Latest Solvency 2 capital impact assessment (based on draft rules)	8 th Sept 2014
Relevant correspondence with regulators	11 th Sept 2014
Actuarial Function Holder Report on proposed transfer from M&G	1 st Draft: 23 rd Sept 2014 Final Draft: 22 nd Jan 2015
With-Profits Actuary Report on proposed transfer from M&G	1 st Draft: 2 nd Oct 2014 Final Draft: 22 nd Jan 2015
Independence Policy	10 th December 2014
Note on Solvency II treatment of "ring fenced funds"	10 th December 2014
Note on management of derivatives	9 th December 2014
Note on policy run-off	9 th December 2014

Other documents provided

Item	Date received
Scheme of Transfer	1 st Draft: 28 th Aug 2014 Final Draft: 22 nd Jan 2015
Implementation Agreement of Transfer	28 th Aug 2014
Combined balance sheet of post-transfer M&G Sub-Fund and SF	23 rd Sept 2014
Post Transfer PPFM for the M&G Sub-Fund	4 th December 2014

Appendix D. Glossary

Term	Description
Actuarial Function Holder or "AFH"	The person holding the role of the Actuarial Function Holder as defined in the Regulatory Handbook.
Annual bonus	A bonus allocated to a with-profits policy annually and determined in line with principles and practices set out in the PPFM.
Asset Share	The value of premiums less allowances for expenses, tax and the cost of risk benefits, accumulated at a rate of return based on the actual income and growth of the assets backing a with-profits policy.
Available Capital	The part of the assets held by an insurer which is not required to meet its regulatory liabilities.
Capital Resource Requirement	The minimum amount of capital that an insurer needs to hold under the Pillar 1 basis, as prescribed by the PRA.
Court	Her Majesty's High Court of Justice of England and Wales
EA	Enhanced Annuities, annuity policies where the annuity income level offered to a policyholder was based on the health status of the policyholder
Effective Date	The date on which the Transfer will take effect. This is expected to be 1 st June 2015.
EIOPA	European Commission and the European Insurance and Occupational Pensions Authority, an organisation comprising local insurance and pension regulators in the EU
Estate	The excess of the value assets in a with-profits fund over a realistic assessment of the liabilities in the fund (taking into account the reasonable expectations of the policyholders)
FCA	Financial Conduct Authority
Fundamentals of Financial Management, or "FFM"	An agreed set of principles laid out under the terms of the Transfer which governs the future management of the M&G Sub-Fund
FIA Policies	Flexible Income Annuities, a with-profits investment linked annuity product where the income is reviewed periodically and is subject to a guaranteed minimum amount. Policyholders retain investment control by choosing from a range of internal unit funds.
Final bonus	A one-off bonus allocated to a with-profits policy on exit and determined in line with principles and practices set out in the PPFM.
Free Assets, or Excess Capital	The excess of Available Capital over Capital Requirement
FSMA	Financial Services and Markets Act 2000

ICE	ICE Acquisitions S.A.R.L., a subsidiary of TDR Capital LLP
ICE Transaction	The transaction between M&G and ICE which completed in November 2013
ICG	Individual Capital Guidance, issued by the PRA to an insurer, which sets out the PRA's view of the amount and quality of capital it believes the insurer needs to hold
Individual Capital Assessment (or "ICA")	An insurer's individual assessment of the amount of capital required to meet each its liabilities in adverse circumstances, taking into account its own assessments of the risks faced. The ICA is in addition to the requirement to demonstrate solvency on a "Pillar 1" basis. While ICAs must be regularly submitted to the PRA, they are not usually disclosed to the public.
International policies	M&G with-profits policies of previously sold by MGM International Assurance
LANMAS Sub-Fund	A ring-fenced fund in SF containing assets and liabilities with respect to business transferred from London Aberdeen & Northern Mutual Assurance Society
M&G	Marine and General Mutual Life Assurance Society Limited
M&G Sub-Fund	A ring-fenced fund in SF established by the Transfer into which the majority of the assets and liabilities of M&G will be transferred as a result of the Transfer
MGM Advantage Services Limited, or "ServCo"	Current external provider of administrative services to M&G
MGMA	MGM Advantage Life Limited
Monitoring Committee	A sub-committee established by SF to provide independent oversight of the M&G Sub-Fund and oversee its integration with SF in line with the terms of the Transfer following the Effective Date. It will also provide a source of knowledge and experience as to the nature of the business within the M&G Fund.]
Non-Profit business	Insurance contracts which are not with-profits insurance contracts. These contracts do not participate in the profits of the insurance company.
Peak 1	Part of the Pillar 1 solvency basis, where the assets are based on market values (subject to certain admissibility restrictions) and the liabilities are calculated on prudent assumptions (but without allowance for future bonuses on with-profits policies)
Peak 1 Capital Ratio	Peak 1 Available Capital divided by Peak 1 liabilities
Peak 2	Part of the Pillar 1 solvency basis, the assets are also based on market values but some assets which are not admissible under Peak 1 may be taken into account. The liabilities are calculated on realistic assumptions (with allowance for future bonuses on with-profits policies) and the capital requirement is calculated based on defined stress scenarios.

Peak 2 Capital Ratio	Peak 2 Available Capital plus “planned enhancements” divided by Peak 2 liabilities (including non-profit business)
Staff Pension Plan	MGM Assurance Staff Pension Plan, a defined benefit pension scheme for employees and ex-employees of M&G which is closed to future accrual.
Pillar 1	Solvency calculations performed by an insurer, as submitted annual in the returns to the PRA (“PRA Returns”), which is a publicly available document
Pillar 2	For the purpose of this report, analogous to the higher of the ICA and the ICG
PRA	Prudential Regulation Authority
Regulatory Handbook	Rules and guidance issued by the PRA and FCA in their respective Handbooks
PRA Returns	Annual regulatory returns submitted to PRA disclosing solvency information amongst other data to the regulatory authority
Principles and Practices of Financial Management	A document published in respect of a with-profits fund, which sets out the principles and practices governing the operation and management of the relevant with-profits business
Rational Shelley Sub-Fund	A ring-fenced fund in SF containing assets and liabilities with respect to business transferred from Rational Shelley Friendly Society
Run-off Plan	A document submitted by M&G to the PRA setting out its plans for the management of the business following closure to new business
ServCo	MGM Advantage Services Limited
SF Independent Person	The person fulfilling the role of the with-profits advisory arrangement for SF, as defined in the PRA FCA Handbook. Their role includes independently reviewing SF’s compliance with its PPFMs
SF Main Fund	The main operating fund and provider of working capital for SF
Scottish Legal Sub-Fund	A ring-fenced fund in SF containing assets and liabilities with respect to the business transferred from Scottish Legal Life
SF	Scottish Friendly Assurance Society Limited
Solvency 2	A new EU-wide regulatory regime for the insurance industry due to take effect from 1 January 2016
The “Scheme”, or the “terms of the Transfer”	The legal documentation setting out the terms for the Transfer (which includes, inter alia, the FFM)
Sub-funds	Collectively, ring-fenced funds of SF which are not the SF Main Fund
The Transfer	The proposed transfer of the long-term business of M&G to SF under Part VII of the Financial Services and Markets Act 2000
Unit-Linked business	Insurance contracts providing benefits which are directly linked to the underlying value of unit-linked investments. These contracts do not

	participate in the profits of the insurance company.
With-Profits Actuary or "WPA"	The person holding the role of the With-Profits Actuary as defined in the Regulatory Handbook.
With-Profits business	Insurance contracts where the policyholder is eligible to participate in any surplus arising on the whole or any part of the insurer's long term business.

Appendix E. Details of FIA policies

These contracts are with-profits investment annuities. The proceeds of approved pension arrangements are invested in a range of internal funds maintained by M&G but which may be invested in external unitised investments managed by third parties. The policyholder selects investment funds in line with his/ her personal risk appetite and selects an income level subject to prescribed limits based on annuity rates then current. A minimum income rate is guaranteed at the outset and underpins the income taken throughout the term of the contract.

An annual management charge (AMC) applies to the unit linked funds to cover administration and the cost of the guarantees. The AMC varies by investment fund, policyholder age and income level. The AMC is reviewable at the discretion of M&G.

There are 2 types of bonus applicable to FIA. The Lifetime Bonus relates to the sharing of the FIA mortality experience amongst FIA policyholders. Subject to a smoothing mechanism, the expected release of investment pools which occurs on death is credited to the investment accounts of remaining FIA policyholders. Although termed a bonus, the Lifetime Bonus is not regarded as a distribution of the Society's surplus as the crediting procedure aims to replicate the operation of mortality in a conventional annuity. The Lifetime Bonus is expected to result in FIA policyholders bearing all of the mortality / longevity risk related to their contracts.

The second bonus type is a Member Bonus which is added annually at the discretion of the Board and reflects the surplus arising on the FIA business, along with any other amount the Board allocates to it from general surplus. The margins from FIA contracts make a relatively low contribution to the risk bearing capacity of M&G.

The level of income which can be drawn is reviewed every 3 years (5 years for a small number of policies sold when the product was first launched) since the supportability of the income chosen is dependent upon investment returns being in line with requirements since the last review, mortality experience not being better than expected and Member Bonuses being added at an appropriate rate.

FIA contracts may be surrendered (subject to constraints). The surrender value generally reflects the value of units allocated but may be reduced to recover previous over-allocation of Lifetime Bonuses and may be subject to reduction to reflect the state of health of the policyholder. (These adjustments are required to ensure the fair treatment of other FIA policyholders.)

The unit funds backing the FIA business were reinsured into MGMA to maintain an efficient investment structure for FIA policyholders. This does not transfer the economic interests in FIA to MGMA. Although the Society pays fees for the management and administration of the FIA business to ServCo under the services agreement, it retains the charges levied on the FIA policies and remains liable for the minimum income guarantee on these policies. The Society has a charge over assets of MGMA sufficient to cover the reinsured FIA liabilities.

Appendix F. Analysis of M&G solvency position before and after Transfer

This appendix sets out further details on the financial impact of the Transfer on M&G and the M&G Sub-Fund, based on the Pillar 1 solvency position as at 31 December 2013.

As part of my review, I have been provided additional information and analysis performed by M&G which shows a pro-forma pre-Transfer balance sheet position assuming the following events (which were not directly related to the Transfer):

- The reinsurance of Standard and Select annuities came into effect retrospectively at 31st December 2013
- The Part VII transfer of the EA policies to MGMA came into effect retrospectively at 31st December 2013
- Distribution of £9m to M&G members and payment of £9m into the Staff Pension Plan was made at 31st December 2013

The post-Transfer Pillar 1 solvency position of the M&G Sub-Fund then shows the financial impact of the Transfer (as described in section 4.1), in particular taking into account:

- The transfer of the unit-linked business and term assurance business into the SF Main Fund
- £10m contribution by the SF Main Fund into the M&G Sub-Fund
- The fixed per policy annual administration fees and investment management charges agreed under the terms of the Transfer

The respective Pillar 1 solvency positions and solvency ratios as at 31st December 2013 are summarised below:

£m	Actual	Pro-forma pre-Transfer	M&G Sub-Fund (post- Transfer)
Peak 1 calculations			
Assets	1,101.7	784.0	385.0
Liabilities	(1,011.7)	(720.0)	(305.0)
Available Capital	90.0	63.0	80.0
Capital Requirement	(68.9)	(38.0)	(37.0)
Free Assets	21.1	25.0	43.0

Peak 2 calculations			
Assets	1,101.7	784.0	385.0
Liabilities (excluding planned enhancements)	(1,036.0)	(748.0)	(330.0)
Planned enhancements	(65.7)	(36.0)	(55.0)
Available Capital	0.0	0.0	0.0
Capital Requirement	0.0	0.0	0.0
Free Assets	0.0	0.0	0.0

Reported Pillar 1 position			
Assets	1,101.7	784.0	385.0
Liabilities	(1,011.7)	(720.0)	305.0
Available Capital	90.0	63.0	80.0
Capital Resources Requirement	(90.0)	(63.0)	(80.0)
Free Assets	0.0	0.0	0.0

Source: M&G PRA Returns as at 31st December 2013, additional M&G analysis

	Actual	Pro-forma pre-Transfer	M&G Sub-Fund (post- Transfer)
Peak 1 Capital Ratio	9%	9%	26%
Peak 2 Capital Ratio	6%	5%	17%

Source: Oliver Wyman

As shown in the table above:

- The combination of events which have already occurred or will occur prior to the Transfer (and not directly related to the Transfer) resulted in a marginal increase in M&G's Peak 1 Free Assets from £21.1m to £25m as at 31st December 2013
- M&G's Peak 1 Capital Ratio was unchanged due to events prior to Transfer.

- M&G's Peak 2 "planned enhancements" reduced due to the events prior to Transfer as described above, including the £10m distribution to members and the reinsurance of the standard annuities (which reduced liabilities by roughly a third), as at 31st December 2013. There was a marginal reduction in M&G's Peak 2 Capital Ratio due to events prior to Transfer, from 6% to 5%.
- The Transfer would result in a significant improvement in the M&G Sub-Fund's solvency position under both the Peak 1 and Peak 2 measures, with Pillar 1 Free Assets increasing by £18m and Pillar 2 "planned enhancements" increasing by £17m when compared against the pro-forma pre-Transfer position as at 31st December 2013
- The Transfer would also result in a significant increase in the Peak 1 Capital Ratio (from 9% to 26%) and Peak 2 Capital Ratio (from 5% to 17%).



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