# Scottish Friendly Assurance Society Limited

A report on a proposed transfer of business from Canada Life Limited pursuant to Part VII of the Financial Services and Markets Act 2000.

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With-Profits Actuary, Scottish Friendly

For and on behalf of Hymans Robertson LLP
7 June 2019

Strictly Confidential

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# 1 Background and overview

## Introduction

1.1 Scottish Friendly Assurance Society Limited ("Scottish Friendly") has agreed to acquire a block of long-term insurance business (the "transferring business") from Canada Life Limited ("Canada Life"). The proposed transfer to Scottish Friendly will be achieved by a Scheme of Transfer ("the Scheme") pursuant to Part VII of the Financial Services & Markets Act 2000 ("FSMA"). The Scheme is subject to approval by the High Court. The Scheme Effective Date is expected to be 1 November 2019, at which point the transferring business will transfer from Canada Life to Scottish Friendly.

1.2 In order to ensure the effective transfer of certain transferring policies held by policyholders who are resident in Jersey or Guernsey, Scottish Friendly and Canada Life are also proposing to implement separate schemes to be presented to the Royal Court of Jersey and the Royal Court of Guernsey (the "Jersey Scheme" and the "Guernsey Scheme" respectively). These schemes will provide for the transfer of policies on the same terms as the Scheme and are expected to be implemented on the same date as the Scheme.

1.3 The purpose of this report is to review and outline the proposed Scheme and to assess its expected impact on the interests of Scottish Friendly's existing with-profits policyholders and its expected impact on the membership rights of all existing policyholders. Specifically, I have considered how the proposed Scheme is expected to affect the security of future benefits, the benefit expectations, and the fair treatment of existing Scottish Friendly with-profits policyholders prior to and beyond the transfer. This covers with-profits policyholders in the SF Main Fund and the existing sub-funds. I have not considered the transfer from the perspective of the transferring Canada Life policyholders.

1.4 I have written this report at the request of the Board of Scottish Friendly in my capacity as Scottish Friendly's With-Profits Actuary, and this report is addressed to the Board. I understand that a copy of my report will accompany the requisite application to the High Court requesting the sanctioning of the Scheme, and accordingly that it may be made available to policyholders and other parties affected by the Scheme.

1.5 Additionally, my report will be made available:

- to Mr Simon Grout of Oliver Wyman Ltd who has been retained by the Boards of Scottish Friendly and Canada Life to report in the capacity as Independent Expert pursuant to Section 109 of FSMA in connection with the proposed transfer,
- to Mr Alan Rankine, Scottish Friendly's Chief Actuary,
- to Mr Chris Lewis, Canada Life's Chief Actuary,
- to Mr Hitesh Shah, Canada Life's With-Profits Actuary,
- to the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA"), and
- on Scottish Friendly's website as part of its publicity of the proposed transfer.

1.6 Permission is hereby granted for such distribution and publication on the condition that the entire report is so distributed or published. I am content for the report to be relied upon by Mr Grout and Mr Rankine, for it to be read by Mr Lewis, Mr Shah, the PRA and the FCA, and for it to be made available on Scottish Friendly's website as part its publicity of the proposed transfer.

## Summary conclusion

1.7 It is my opinion that:

- the Scheme does not have a materially adverse effect on the security of benefits, benefit expectations, or the fair treatment of Scottish Friendly's existing with-profits policyholders,
- the Scheme does not result in a significant dilution of membership rights, and that
- there is no reason, in those terms, why the transfer should not proceed.

The basis for this conclusion is developed throughout the rest of this report, which must be read in its entirety.

## Status, credentials and declarations of interest

1.8 I am a Fellow of the Institute and Faculty of Actuaries ("IFoA"), having qualified in 1999. I have held the Chartered Enterprise Risk Actuary designation since 2011. I hold the Chief Actuary (Life), Chief Actuary (Life, Non-Directive), and With-Profits Actuary practising certificates issued by the IFoA.

1.9 I held the role of Interim Chief Actuary of Scottish Friendly from 16 April 2018 to 19 November 2018. During this time the Business Transfer Agreement ("BTA") for this transfer of business was signed, in advance of which I advised the Board of Scottish Friendly on the expected impact of, and the principal risks associated with, the proposed transfer.

1.10 I am a partner of Hymans Robertson LLP ("Hymans Robertson"). Beyond the fees payable to Hymans Robertson by Scottish Friendly under the terms of a Service Order effective 3 December 2018, I have no financial interest in either company. Specifically, neither I nor my immediate family have any policies, investments, or other holdings in Scottish Friendly, Canada Life, or in any parent, sister or subsidiary company.

1.11 Other partners and staff of Hymans Robertson have advised, and continue to advise, Scottish Friendly and Canada Life on various other matters. These have not influenced my report and its conclusions.

## Other advice and opinions

1.12 In their capacities as described in paragraph 1.5, Mr Grout, Mr Rankine, Mr Lewis and Mr Shah have each prepared reports on the Scheme. I have read drafts of their reports and noted their conclusions. I have relied on Mr Rankine's report and in particular his conclusions in respect of the impact of the proposed Scheme on the solvency position of Scottish Friendly.

## Reliances and limitations

1.13 In preparing this report I have relied without independent verification on the accuracy and completeness of information provided by Scottish Friendly, including information received orally. Appendix A sets out the documents supplied to me and which I have considered in preparing my report.

1.14 To the extent that the information supplied in connection with the proposed transfer and associated agreements is incomplete or inaccurate, or should these change, this may materially impact my report and its conclusions. In that regard:

- my report should be considered in the context that a number of aspects relating to the Scheme are in draft form and may be subject to change, which may alter my conclusions, and
- prior to the final Court hearing to sanction the Scheme, I expect to prepare a supplementary report for the Board of Scottish Friendly, appraising it of any major developments affecting the proposed transfer, including any implications in relation to existing Scottish Friendly with-profits policyholders.

1.15 Hymans Robertson accepts no liability to any third parties unless it has accepted such liability in writing. Other than as envisaged in paragraph 1.5, my report must not be recited, referred to, published, quoted, distributed, released, replicated, reproduced or modified (in whole or in part) except as required by law, regulatory obligation, or as set out in the Service Order referred to in paragraph 1.10, without prior written consent. Should consent be given, my report may only be released in its entirety and without modification.

1.16 Draft versions of the report must not be relied upon by any person for any purpose.

1.17 My report should not be interpreted as fact or likelihood or expectation of a particular financial outcome. Investment, demographic, expense and other experience may ultimately differ (either positively or adversely) from expectations.

1.18 It is assumed that readers of this report have (or are advised by others who have) appropriate knowledge of matters relating to transferring portfolios of long-term insurance business in a Solvency II environment as well as the management of with-profits business as this is required to understand the analysis and opinions presented.

1.19 Nothing in this report should be considered to be investment, accounting, tax or legal advice, all of which are outside of the scope of my engagement. My report is based upon my understanding of circumstances and events as at its date.

### Compliance with professional standards

1.20 The Financial Reporting Council sets out technical actuarial standards for members of the IFoA. This report is subject to and complies with the following standards:

- Technical Actuarial Standard 100: Principles for Technical Actuarial Work, and
- Technical Actuarial Standard 200: Insurance.

1.21 In addition, the IFoA sets professional standards for its members. This report has been prepared having due regard to and in compliance with the requirements of the following Actuarial Profession Standards:

- APS L1: Duties and Responsibilities of Life Assurance Actuaries. I believe that I have had access to sufficient information and resources, including the opinion of Scottish Friendly's Chief Actuary, in preparing my report.
- APS X2: Review of Actuarial Work. This report is subject to and complies with the requirements for independent peer review set out in APS X2.

### Glossary of terms

1.22 Throughout this report, including in this introduction, a number of terms and abbreviations are used. These are typically defined where first used, but they are summarised in the glossary of terms in Appendix B.

### Structure of Report

1.23 The remainder of my report is structured as follows:

- Section 2 provides background to Scottish Friendly,
- Section 3 provides an overview of the transferring business,
- Section 4 assesses the impact of the Scheme on Scottish Friendly's existing with-profits policyholders, and
- Section 5 summarises my conclusions on the impact of the Scheme.

There then follow two appendices. Appendix A sets out the documents supplied which I have considered in preparing my report, and Appendix B lists the various terms and abbreviations used in this report.

# 2 Scottish Friendly

## Introduction and company history

2.1 Scottish Friendly traces its origins back to 1862 as the City of Glasgow Friendly Society, a friendly society. In the early 1990s, the City of Glasgow Friendly Society acquired Scottish Friendly and rebranded itself as the Scottish Friendly Assurance Society.

2.2 Scottish Friendly is a friendly society incorporated under the Friendly Societies Act 1992 and regulated by the PRA and by the FCA. As a mutual society, Scottish Friendly has no shareholders and is owned by its members. Scottish Friendly has a Board of Directors, which is its ultimate governing body. Distribution of surplus and declaration of bonuses is determined by the Board upon the advice of the With-Profits Actuary.

2.3 At 31 December 2018 Scottish Friendly's assets under management were over £2.6bn with 1.27 million policies (corresponding to 594,000 members) across a range of with-profits, unit-linked and other non-profit policies.

2.4 Scottish Friendly has a three-part growth strategy of organic growth, mergers and acquisitions ("M&A"), and business process outsourcing. Scottish Friendly's recent M&A activity is as follows:

- On 31 December 2005, Rational Shelley Friendly Society ("Rational Shelley") transferred its business to Scottish Friendly.
- On 31 May 2006, Preston Operative Assurance ("Preston Operative") transferred its business to Scottish Friendly.
- On 1 July 2007, Pioneer Friendly Society ("Pioneer") transferred its business to Scottish Friendly.
- On 30 September 2007, Scottish Legal Life Assurance Society Limited ("Scottish Legal") transferred its business to Scottish Friendly.
- On 31 December 2007, London Aberdeen & Northern Mutual Assurance Society ("LANMAS") transferred its business to Scottish Friendly.
- On 30 November 2012, Royal Standard Friendly Society ("Royal Standard") transferred its business to Scottish Friendly.
- On 31 May 2015, business was transferred from Marine & General Mutual Life Assurance Society ("M&GM") to Scottish Friendly by means of a Part VII Scheme.
- On 9 November 2018, a block of business was transferred from Mobius Life Limited ("Mobius Life") to Scottish Friendly by means of a Part VII Scheme.

2.5 The Scheme is consistent with Scottish Friendly's established M&A strategy of growing its business through the acquisition of blocks of business from other insurers. Once it has acquired a block of business, Scottish Friendly will normally seek to deliver efficiency savings in how the business is managed.

## Scottish Friendly fund structure

2.6 Scottish Friendly maintains one long-term business fund, the SF Main Fund. Within this structure, separate notional sub-funds are maintained in respect of business (including the with-profits business) that transferred from Scottish Legal, LANMAS, Rational Shelley and M&GM. The with-profits business in each sub-fund has its own investment strategy and bonus rates, managed in accordance with each sub-fund's Principles and Practices of Financial Management ("PPFM").

| Long-term business fund | | | | |
|---|---|---|---|---|
| SF Main Fund | Scottish Legal | LANMAS | Rational Shelley | M&GM |

2.7 The business within each of the funds is broadly as follows:

- SF Main Fund: with-profits business, both conventional and unitised, together with significant volumes of unit-linked life and pension business, such as ISAs, non-profit whole of life policies and term assurance business (most of which is reinsured).
- Scottish Legal: with-profits business, both conventional and unitised, together with unit-linked life and pension business, significant volumes of non-profit whole of life policies and small volumes of term assurance business.
- LANMAS: unitised with-profits business, together with unit-linked life and pension business and a small number of term assurance policies.
- Rational Shelley: conventional with-profits business and whole of life policies.
- M&GM: with-profits business, both conventional and unitised, immediate annuities and flexible income annuities.

2.8 All Scottish Friendly policyholders are members of Scottish Friendly, whether their policies have been written in, or transferred to, the SF Main Fund or any of its sub-funds.

### SF Main Fund

2.9 The SF Main Fund contains policies written by Scottish Friendly, along with business obtained through the acquisition of Royal Standard, Preston Operative and Pioneer. A block of unit-linked and term assurance business was transferred from M&GM into the SF Main Fund as part of the acquisition of business from M&GM in May 2015. In addition, the SF Main Fund holds a block of unit-linked pension business that transferred from Mobius Life in November 2018. The SF Main Fund is open to new business.

2.10 Profits are expected to emerge in the SF Main Fund from:

- non-profit business written in, or transferred into, the SF Main Fund,
- subsidiaries of Scottish Friendly, and
- administration of business written within the LANMAS, Rational Shelley and M&GM notional sub-funds. The SF Main Fund makes a charge against each of the notional sub-funds in line with the relevant Schemes and the difference between those charges and the actual costs incurred in administering the business within the notional sub-funds emerges as a profit for the SF Main Fund.

2.11 In the first instance these profits are attributed to the working capital of the SF Main Fund. However, the Board agreed in 2015 that a mechanism should be established for distributing these profits to with-profits policyholders. Each year an assessment is made of the profits emerging from the sources listed in paragraph 2.10, and a share is distributed by means of enhancing the investment returns applied to asset shares of with-profits policies in the SF Main Fund. For the avoidance of doubt, any enhancement following such an assessment is entirely discretionary and this practice may be varied should that be deemed appropriate by the Board.

### Other sub-funds

2.12 The Scottish Legal, LANMAS, Rational Shelley and M&GM notional sub-funds contain policies written by Scottish Legal, LANMAS, Rational Shelley and M&GM prior to their transfer to Scottish Friendly. The charges made against policies within these sub-funds are governed by the relevant scheme of transfer. These sub-funds are closed to new business, ring-fenced for the benefit of the relevant policyholders, and in run off.

### With-profits governance within Scottish Friendly

2.13 The Board of Scottish Friendly is responsible for the management of the SF Main Fund and the sub-funds. In this regard the Board is advised by the With-Profits Actuary and it has historically also been advised by the With-Profits Advisory Arrangement ("WPAA").

2.14 As part of its ongoing role as a conduct regulator for insurers, the FCA undertook over 2018 and 2019 a thematic review of how with-profits business is managed in the UK. In light of that exercise, Scottish Friendly is implementing a number of actions relating to how it manages its with-profits business, including a review of its with-profits governance arrangements to ensure that they remain appropriate for its business after the transfer.

2.15 The governance review work completed in early 2019, as a result of which Scottish Friendly has established a With-Profits Committee ("WPC") to replace its WPAA in advising the Board. The Board continues to be advised by the With-Profits Actuary.

2.16 This new governance structure is the mechanism by which the interests of with-profits policyholders are appropriately considered. An important aspect of this is ensuring that discretion, for example in the determination of bonus rates, is exercised in an appropriate manner and ensures the fair treatment of policyholders. Another important aspect is advising the Board on the expected impact on existing with-profits policyholders of significant business proposals, such as the Scheme.

2.17 The WPC's first meeting took place on 28 May 2019. While separate to and unaffected by the Scheme, this early establishment of the WPC relative to the Scheme Effective Date will help to ensure a smooth transition of the transferring business, as well as its robust ongoing management.

2.18 The thematic review has led to Scottish Friendly undertaking a number of other actions relating to the management of its with-profits business. While not all of these actions have been completed as at the date of this report, I am satisfied that they are not financially material to Scottish Friendly and their ultimate completion will not invalidate my report.

# 3 Summary of the Scheme

### Summary of the transferring business

3.1 The transferring business is formed of around 134,000 policies with c.£2.3bn of net best estimate liability ("BEL") (on a Solvency II Pillar 1 basis) as at 31 December 2018, and is made up of:

- c.£2.1bn of non-profit business managed in a non-profit fund, comprising a wide range of unit-linked life (c.£0.4bn), unit-linked pensions (c.£1.5bn), and non-linked life, pensions and protection business (c.£0.2bn), and
- c.£0.2bn with-profits and non-profit business in the Manulife ring-fenced with-profits fund ("the Manulife Fund"), mainly comprising with-profits whole-of-life business.

3.2 A breakdown of the transferring business is shown in the following table:

| As at 31 December 2018 | Policy count | Net BEL (£m) | Description |
|---|---|---|---|
| Unit-linked life business | 24,064 | 441.4 | Predominantly whole of life assurances, endowments and investment bonds. |
| Unit-linked pensions business | 77,932 | 1,532.4 | Predominantly individual pensions. Also includes c.3,000 workplace pensions. |
| Non-linked life business | 10,730 | 108.5 | Predominantly protection business. Also includes endowment and whole-of-life policies that have been converted from with-profits. |
| Non-linked pensions business | 322 | 18.8 | Predominantly annuities. Includes some policies that have converted from with-profits. |
| Non-linked protection business | 8,320 | 19.2 | Predominantly income protection and critical illness policies. |
| Business contained in the Manulife Fund | 12,322 | 158.6 | Predominantly with-profits business. Also includes c.2,200 non-profit policies. |
| **Total** | **133,690** | **2,279.0** | |

*Source: Scottish Friendly Chief Actuary's report on the Scheme*
*"Net BEL" refers to the Solvency II best estimate liabilities, net of reinsurance recoverables*

### Effect of the transfer

3.3 While the transfer of business is undoubtedly material in the context of Scottish Friendly's existing operations (for example, as measured by assets under management), I would note that the vast majority of the business transferring is unit-linked, where liabilities are largely driven by the value of associated unit funds. The expected financial impact of the transfer is discussed in paragraph 4.7.

3.4 Scottish Friendly will set up a new ring-fenced sub-fund, the Manulife sub-fund, which will contain the business that is being transferred from Canada Life's Manulife Fund. The remainder of the transferring business will be transferred to the SF Main Fund. The Manulife sub-fund will be operated as a closed ring-fenced sub-fund for the benefit of the transferring Manulife policyholders, consistent with its operation in Canada Life. Specifically, there are no plans to open the Manulife sub-fund to new business, to wind it up, or to merge it with another fund or sub-fund.

3.5 It is anticipated that, following the implementation of the Scheme, Scottish Friendly will put in place an arrangement under which the SF Main Fund will provide capital support to the Manulife sub-fund in circumstances where the Manulife sub-fund would otherwise be unable to cover its liabilities. The Scheme contains provisions which prevent the Manulife sub-fund from providing capital support to the SF Main Fund, or any of the other sub-funds. In the extremely unlikely event that Scottish Friendly were to become insolvent, it is possible that some of the assets in the Manulife sub-fund may become available to help meet benefits payable on policies outside the Manulife sub-fund.

3.6 For the avoidance of doubt, the operation of the current capital support arrangements and the existing sub-funds will be unaltered by the Scheme

3.7 Scottish Friendly will take over the administration of the transferring business. Scottish Friendly will enter into an outsourcing arrangement with Canada Life under which Canada Life will continue to perform investment management, investment administration, and fund pricing for the transferring unit-linked business following the implementation of the Scheme. Scottish Friendly will manage the assets backing the non-linked liabilities that are being transferred to the SF Main Fund, as well as all of the assets transferring to the Manulife sub-fund.

3.8 For the avoidance of doubt, the Scheme will not alter the provisions of Scottish Friendly's Memorandum and Rules which govern the operation of the SF Main Fund, and nor will it alter the provisions of previous schemes concerning the operation of the various existing sub-funds. This includes all existing mechanisms for merging, closing or splitting the SF Main Fund or any of the sub-funds.

### Membership rights

3.9 Following the implementation of the Scheme, all holders of transferring policies will become members of Scottish Friendly. They will then have the ability to nominate and vote for delegates to represent them and their interests. The Scheme will not result in an increase in the number of delegates and will therefore result in existing delegates taking responsibility for these new members.

### Assets transferred

3.10 In consideration for assuming the obligations relating to the transferring business, Scottish Friendly will receive assets with a value equal to the Solvency II technical provisions for the transferring business, plus an additional amount that is expected to be £50m.

3.11 For the purpose of determining the value of transferring assets, technical provisions will be equal to the sum of a BEL plus a risk margin with no allowance for the transitional measure on technical provisions. The BEL will be calculated using demographic and expense assumptions set out in the BTA and the risk-free rate (as published by the European Insurance and Occupational Pensions Authority) as at the Scheme Effective Date.

3.12 The additional amount that is paid over and above the value of technical provisions will be £50m provided that the standalone Solvency Capital Requirement ("SCR") for the transferring business, determined on a Solvency II Standard Formula basis, is between £40m and £60m. If the standalone SCR falls outside of this range then the additional amount will be equal to the standalone SCR.

3.13 The value of transferring assets significantly exceeds the value of the BEL calculated on the prescribed basis, which, owing to expense efficiencies expected to be achieved in Scottish Friendly, is in turn expected to exceed the value placed on the BEL by Scottish Friendly. Charges on unit-linked business will also be greater than assumed in the calculation of the technical provisions if the assets held in the linked funds achieve a return in excess of the risk-free rate. In the fullness of time, the Scheme is therefore expected to generate a significant profit for Scottish Friendly.

### Cost of implementing the Scheme

3.14 Scottish Friendly and Canada Life will each meet their own transaction costs, such as legal and consultancy fees, and costs incurred in carrying out the migration. Shared costs, such as the Independent Expert and Legal Counsel, will be shared equally between Scottish Friendly and Canada Life.

### With-profits governance arrangements

3.15 Following the implementation of the Scheme, the Board of Scottish Friendly will become responsible for the management of the with-profits business in the new Manulife sub-fund.

# 4 The impact of the Scheme on with-profits policyholders and members

4.1 In this section I discuss the impact that the Scheme is expected to have on Scottish Friendly's existing with-profits policyholders and on the membership rights of all policyholders.

4.2 Existing with-profits policyholders may be affected if the Scheme is expected to alter their benefit expectations. Their interests may also be affected if the Scheme impacts Scottish Friendly's ability to meet its obligations to them and I therefore consider the impact of the Scheme on Scottish Friendly's financial strength.

4.3 Additionally, I consider:

- the impact on membership rights,
- whether the Scheme is consistent with the fair treatment of customers,
- the impact of the Scheme on policy administration,
- the proposed communications strategy, and
- the impact of the Scheme on Scottish Friendly's tax position.

## Benefit security

### Background

4.2 UK insurance companies are required, by law, to maintain a minimum level of capital resources to reduce the risk that they are unable to meet their future obligations to policyholders following adverse events. Under Solvency II, the current regulatory requirement for insurers and reinsurers in the European Union, this calculation is performed on two different bases.

### First basis: Pillar 1

4.3 The first basis is an assessment of the "own funds" available compared to the capital required to be covered.

4.4 Broadly speaking, the value of a firm's own funds is the market value of its assets less the value of its technical provisions and other liabilities. Technical provisions are intended to represent the amount that an insurer would need to pay to immediately discharge its obligations to policyholders by transferring the business to another insurer in an arm's length transaction. Since the price of such a transaction is not readily observable in the financial markets, a theoretical transfer value is determined, equal to a best estimate liability plus a risk margin.

4.5 The regulations require insurers to maintain own funds in excess of the SCR. The value of a firm's SCR is calculated by determining the amount by which the insurer's own funds could fall over the course of one year such that the probability that the reduction in own funds exceeds the SCR over that one-year period is 0.5%.

### Second basis: Pillar 2

4.6 The second basis requires firms to make their own assessment of the amount of capital they need to hold, based on the risks to which they are exposed, approved risk tolerance limits, and the business strategy, to ensure that they remain able to meet their liabilities to policyholders in all but the most extreme circumstances. This calculation is referred to as the Own Risk & Solvency Assessment ("ORSA"), also known as Pillar 2, which also includes a forward-looking assessment of the firm's risks and capital position.

## Financial impact of implementing the Scheme

4.7 Scottish Friendly's Chief Actuary has estimated the impact that implementing the Scheme is expected to have on Scottish Friendly's financial position. The table below shows:

(i) Scottish Friendly's Pillar 1 regulatory balance sheet as at 31 December 2018 as reported in its 2018 Solvency and Financial Condition Report, and

(ii) a pro-forma balance sheet as at 31 December 2018 allowing for the business to be transferred under the Scheme. Note that this allows for Scottish Friendly's costs of effecting the Scheme, as well as the beneficial impact that the administrative efficiencies arising from the Scheme are expected to have on the firm's expenses.

| Pillar 1 position as at 31 December 2018 (£m) | Reported | Post Canada Life transfer |
|---|---|---|
| Assets [A] | 2,633.2 | 5,005.2 |
| Liabilities [B] | 2,447.1 | 4,761.2 |
| **Excess of assets over liabilities [C] = [A]-[B]** | **186.1** | **243.9** |
| Impact of ring-fencing [D] | (75.3) | (75.3) |
| **Own funds [E] = [C]+[D]** | **110.8** | **168.6** |
| **SCR [F]** | **58.8** | **98.2** |
| **Solvency coverage ratio [G] = [E]/[F]** | **188%** | **172%** |

*Source: Scottish Friendly Chief Actuary's report on the Scheme*

4.8 In preparing this analysis, Scottish Friendly's Chief Actuary has considered the impact that the Scheme is expected to have on the financial position of each of the existing sub-funds. As expected, this shows that the Scheme is not expected to affect the own funds or SCR in any of the existing sub-funds. The increase in own funds and SCR (and corresponding dilution of the coverage ratio) shown in the table above arises entirely in the SF Main Fund.

4.9 The table above indicates that, despite the initial reduction in the solvency coverage ratio, Scottish Friendly is expected to continue to comfortably meet its regulatory capital requirements immediately following the implementation of the Scheme. In the fullness of time, the Scheme is ultimately expected to enhance Scottish Friendly's financial position as the risk margin and SCR associated with the transferring business runs off. The firm's ORSA shows a projection of the Pillar 1 solvency coverage ratio, both with and without the expected effect of the transfer. I have reviewed and am satisfied with the results of this comparison.

4.10 Scottish Friendly's risk appetite framework is defined in terms a minimum probability that the firm will continue to meet its regulatory capital requirements in one year's time. For practical purposes, this is expressed in terms of a "minimum" solvency coverage ratio which is reviewed regularly. Separate minima are set for the Pillar 1 and Pillar 2 coverage ratios. If either of the Pillar 1 and Pillar 2 coverage ratios falls below the relevant minimum level then Scottish Friendly would expect to take actions to improve its solvency position. However, provided that the solvency position remains in excess of its risk appetite, Scottish Friendly will actively pursue its agreed business strategy.

4.11 Following the implementation of the Scheme, the Pillar 1 solvency position – as set out in the table above – is expected to continue to satisfy Scottish Friendly's risk appetite framework. The report of Scottish Friendly's Chief Actuary notes that the coverage ratio on a Pillar 2 basis is also expected to continue to satisfy the risk appetite framework. This analysis has been shared with me and, having reviewed its results, I am satisfied with the position that it shows.

4.12 I therefore do not consider that the expected reduction in coverage ratio constitutes a materially adverse effect on benefit security of with-profits policyholders, provided that Scottish Friendly continues to comply with its risk appetite framework.

### Capital support arrangements

4.13 The operation of the capital support arrangements between the SF Main Fund and the existing sub-funds is not affected by the Scheme, albeit the capital support available to the existing sub-funds will be diluted owing to having to support the new Manulife sub-fund. However, given the capital position of the Manulife sub-fund and the correspondingly-remote likelihood of it requiring capital support, and as set out in paragraph 4.21, I do not believe that this dilution will materially weaken the capital support available for the existing sub-funds following implementation of the Scheme.

4.14 The reduction in solvency coverage ratio shown in the table at paragraph 4.7 arises as a result of an increase to the SCR for the SF Main Fund. Given that the sub-funds are ring-fenced, the solvency position of the SF Main Fund is the key driver of Scottish Friendly's overall solvency position – on a Pillar 1 basis, the sub-funds act only to dilute the overall solvency coverage ratio.

4.15 As noted in paragraphs 4.10 and 4.11, the expected solvency position following the implementation of the Scheme satisfies Scottish Friendly's risk appetite framework. As the overall solvency position is driven primarily by the solvency position of the SF Main Fund, it follows that the latter's financial position is expected to remain satisfactory following the implementation of the Scheme.

4.16 Given this, I do not believe that the reduction in solvency coverage ratio indicates that the ability of the SF Main Fund to provide capital support to the M&GM, Scottish Legal, LANMAS and Rational Shelley sub-funds will be materially weaker following the implementation of the Scheme.

### Balance of risks affecting benefit security

4.17 Scottish Friendly's Chief Actuary has analysed the impact that the implementation of the Scheme is expected to have on the risk profile of the SF Main Fund. The table below shows a breakdown of the SF Main Fund's SCR into various risk categories. This is shown as at 31 December 2018 without the implementation of the Scheme, for the transferring business in isolation, and for the hypothetical position had the Scheme been implemented on 31 December 2018. The figures are based on Pillar 1 SCR, prior to any diversification effects.

| Risk category | SF Main Fund pre-transfer | Transferring Business | SF Main Fund post transfer |
|---|---|---|---|
| Market | 22% | 31% | 26% |
| Counterparty default | 9% | 0% | 5% |
| Life underwriting | 61% | 56% | 58% |
| Health underwriting | 0% | 8% | 5% |
| Operational | 8% | 5% | 7% |

*Source: Scottish Friendly Chief Actuary's report on the Scheme*

4.18 Other than as discussed in paragraph 4.19, the table above suggests that the Scheme will not significantly alter the balance of risks that affect the benefit security of existing policyholders in the SF Main Fund.

4.19 Scottish Friendly's Chief Actuary has noted in his report on the Scheme that Scottish Friendly currently has no material exposure to health underwriting risk. However, as demonstrated in the table above, this will change somewhat when c.8,100 income protection policies are transferred to Scottish Friendly under the terms of the Scheme. The Chief Actuary has noted that these policies will require careful claims management, and I agree with this assessment. A key focus of the preparatory work currently being undertaken is to ensure that appropriate processes are in place to manage this potential exposure. I am content with the plans that have been outlined to me, and I will comment on progress made in my supplementary report.

4.20 Aside from the impact of the addition of unit-linked and other non-profit business into the SF Main Fund, the benefit security of all existing with-profits policyholders may also be impacted by the risk that the SF Main Fund may need to provide capital support to the new Manulife sub-fund in extreme circumstances. I note that while the SF Main Fund may need to provide capital support to the Manulife sub-fund, the Scheme prohibits the Manulife sub-fund from providing support to the SF Main Fund (or to any of Scottish Friendly's other sub-funds).

4.21 However, I am satisfied that the likelihood of the Manulife sub-fund "burning through" its own capital and requiring capital support from the SF Main Fund is limited. The reports of Scottish Friendly's and Canada Life's Chief Actuaries note that the Manulife Fund has a significant terminal bonus cushion (c.£39m at 31 December 2018) which is expected to be able to comfortably absorb a loss equal to the size of the SCR (c.£14m at 31 December 2018, before allowing for the impact of the loss-absorbing capacity of technical provisions). SCRs are calibrated to an extreme 1-in-200 one-year level, and the Manulife Fund's capital buffer is significantly in excess of its SCR.

4.22 It is possible that the transferring business will give rise to costs in respect of claims made by transferring policyholders, for example in relation to resolving administrative errors which occurred before the Scheme Effective Date. The transferring business may also give rise to costs in respect of claims of mis-selling. The costs of rectifying any such administrative errors will be borne by Canada Life for claims made within two years of the Scheme Effective Date and the costs of compensating any such mis-selling claims will be borne by Canada Life for claims made within five years of the Scheme Effective Date. Canada Life's total aggregate liability for these claims will be limited to £20m. Claims falling outside of these limits will be borne by Scottish Friendly. I consider these limits to be reasonable. In particular I would note that the business has been in force for a very long time, so the risk of material claims in relation to mis-selling is believed to be small. Scottish Friendly intends to update its PPFMs to set out how any such claims will be met and I will advise the Board on this in due course.

4.23 Bonuses for with-profits policies in the Manulife Fund in Canada Life are determined using the North American Contribution Method, and this practice (among others) will continue after its transfer to Scottish Friendly. Scottish Friendly does not currently use this method and so it will face some additional requirements in setting up the processes required to determine bonuses for Manulife policyholders. While the transition from Canada Life needs to be carefully managed, preparations to take on the management of the business in the Manulife Fund, including PPFMs for the new Manulife sub-fund within Scottish Friendly, are at an advanced stage. I therefore do not consider this to constitute a material risk to Scottish Friendly's existing with-profits policyholders.

### Conclusion in relation to benefit security

4.24 Based on the analysis above:

- the financial position of Scottish Friendly is expected to continue to be comfortably in excess of its risk appetite following the implementation of the Scheme and is expected to be enhanced over time,
- the Scheme will not alter Scottish Friendly's existing capital support arrangements and is not expected to materially affect the ability of the SF Main Fund to provide support under these arrangements, and
- the Scheme is not expected to materially alter the balance of risks that affect the benefit security of Scottish Friendly's existing with-profits policyholders.

4.25 It is therefore my opinion that the Scheme is not expected to have a materially adverse effect on the benefit security of Scottish Friendly's existing with-profits policyholders.

## Benefit expectations

### Contractual benefits

4.26 The Scheme will not alter the terms of any of Scottish Friendly's existing policies, including the guaranteed part of the benefits due under with-profits contracts.

### Investment policy

4.27 As discussed in paragraphs 4.7 and 4.8, the Scheme is expected to temporarily weaken the solvency position of the SF Main Fund. However, as discussed in paragraph 4.15, it is not expected that the SF Main Fund will be weakened to the extent that Scottish Friendly will breach its risk appetite.

4.28 Given this, I do not expect the temporary weakening of the SF Main Fund to warrant any changes to the investment strategy adopted in respect of its asset shares.

4.29 As discussed in paragraph 4.8, the Scheme is not expected to have any impact on the financial position of any of Scottish Friendly's existing sub-funds. I therefore do not expect the Scheme to result in any changes to the investment strategy adopted in respect of assets in any of the existing sub-funds.

4.30 I therefore do not expect the Scheme to result in any changes to the (unadjusted) investment returns credited to the asset shares of existing with-profits policyholders.

### Charges and expenses

4.31 The SF Main Fund makes a charge against each of the M&GM, Rational Shelley and LANMAS sub-funds in line with the relevant Schemes. The basis upon which the charges are determined will not be altered by the Scheme. Scottish Friendly makes expense deductions from the Scottish Legal sub-fund in line with costs incurred.

4.32 The Scheme is expected to result in a reduction to the expenses attributed to the existing policies, since overhead expenses will be spread over a greater number of policies. I therefore do not expect the Scheme to result in an increase in charges or expense deductions, and may indeed result in a reduction.

### Estate distribution

4.33 Scottish Friendly maintains an estate in the SF Main Fund, and this estate has a number of purposes. It acts as working capital for Scottish Friendly in pursuit of its business objectives, including writing new business in the SF Main Fund and seeking other opportunities for growth, such as this Scheme. It acts as a buffer to provide an appropriate level of security to existing policyholders. It also helps Scottish Friendly to meet policyholder expectations, including in relation to supporting investment policy and meeting benefit expectations such as providing a degree of smoothing of pay-outs.

4.34 There is therefore a balance to be had in terms of the size of the estate. If the estate is too small this may compromise Scottish Friendly's ability to pursue its business objectives and to meet and protect existing policyholders' interests. On the other hand, if the estate is too large this could be viewed as being unfair to existing policyholders who might otherwise benefit from receiving a share of it. To that end, and as well as setting out a "minimum" solvency coverage ratio to avoid the estate becoming too small, Scottish Friendly's risk appetite framework sets out an upper tolerance level. If the coverage ratio exceeds this upper level then Scottish Friendly would consider whether the SF Main Fund estate had become excessive.

4.35 Other than where needed to meet benefit expectations, and in respect of the discretionary enhancements referred to in paragraph 2.11, Scottish Friendly is not currently making distributions to policyholders from the SF Main Fund estate and nor does it currently have plans to do so in the future, irrespective of this Scheme. Moreover, the financial position of the SF Main Fund is considerably below the level at which Scottish Friendly would consider whether the SF Main Fund estate had become excessive. Projections in the firm's ORSA show that the coverage ratio is expected to remain below this level for the foreseeable future – and this is the case both with and without the Scheme.

4.36 I therefore do not expect the Scheme to have a materially adverse effect on the potential for distributions to be made to policyholders from the SF Main Fund estate. As noted above, the Scheme will not affect the financial position of the M&GM, Scottish Legal, LANMAS or Rational Shelley sub-funds. I therefore do not expect the Scheme to affect the rate at which the estates of these sub-funds are distributed to policyholders.

### With-profits bonus expectations

4.37 The Scheme will not alter the procedures followed for setting bonuses for Scottish Friendly's existing with-profits policyholders. As set out in Scottish Friendly's PPFMs, bonus rates are generally based on the values of policyholders' asset shares. In paragraphs 4.30 and 4.32 I conclude that the contributions to asset shares from investment returns and expenses are not expected to be changed by the Scheme in a way that would result in lower bonus expectations for existing with-profits policyholders.

4.38 As set out in paragraph 3.13, the business transferred by the Scheme to the SF Main Fund is expected to generate profits in the SF Main Fund. In line with existing practices, with-profits policyholders in the SF Main Fund are therefore expected to receive a share of the profits arising from the non-profit business acquired under the terms of the Scheme. This is ultimately expected to have a positive impact on the benefits of with-profits policyholders in the SF Main Fund.

4.39 It should be noted, however, that the Scheme may ultimately be loss-making for Scottish Friendly. This could occur if, for example, the costs of administering the transferring business were to increase significantly without a commensurate increase in charges, if there were fewer than expected lapses of certain whole-of-life polices, or if material operational risk events were to arise in connection with the transferring business. I note also that the one-off cost of implementing the Scheme may prove to be higher than expected. While a financial loss is considered to be unlikely for the reasons discussed in paragraph 3.13, the effect of this may ultimately result in lower bonuses to existing with-profits policyholders.

### Conclusion in relation to benefit expectations

4.40 Based on the analysis above:

- the Scheme will not alter guaranteed benefits for existing with-profits policyholders,
- the Scheme is not expected to result in changes to the investment strategy of the SF Main Fund or any of the existing sub-funds,
- the Scheme is not expected to result in an increase to the charges or expenses levied on existing with-profits policies,
- the Scheme is not expected to result in any changes to the distributions that policyholders receive from the estates of the SF Main or any of the sub-funds, and
- the Scheme is expected to have a positive impact on the distributions made to with-profits policyholders in the SF Main Fund in respect of profits arising on non-profit business and the management of sub-funds.

4.41 It is therefore my opinion that the Scheme will not have a materially adverse effect of the expectation of benefits of Scottish Friendly's existing with-profits policyholders.

### Membership rights

4.42 All Scottish Friendly policyholders are also members of the society, with attaching voting rights, irrespective of how they came to be with Scottish Friendly. Transferring policyholders will also become members of Scottish Friendly. The result of this will be a dilution of membership rights of existing Scottish Friendly members but I do not consider this dilution to be material as the number of additional members as a proportion of total current membership is relatively small.

4.43 Canada Life's Chief Actuary has prepared a report on the Scheme which states that the transferring business is made up of around 100,000 unique policyholders (as at 31 December 2018). In comparison, Scottish Friendly had around 594,000 members at 31 December 2018. This suggests that voting rights of existing members will be diluted by around 14%.

4.44 One of the benefits of membership of Scottish Friendly is the ability to vote on various matters affecting the firm and its operations. The way in which members exercise their voting rights is through a system of delegate representation where representative members (delegates) are elected to vote on behalf of others.

4.45 As the physical act of voting is carried out by delegates on behalf of members, and as there will be no increase in the number of delegates as a result of the Scheme, the practical effect of the dilution referred to in paragraph 4.42**Error! Reference source not found.** is further limited, albeit that existing delegates will have to consider the interests of a broader range of members when voting after the transfer.

4.46 Paragraphs 4.42 to 4.45 are concerned with membership rights when considering Scottish Friendly as a going concern. It remains to consider the effect of the transfer on the rights of existing members upon dissolution of Scottish Friendly.

4.47 My understanding is that, if Scottish Friendly were to be dissolved, members would receive an equitable share of surplus assets as determined by the Board on appropriate actuarial advice. As Scottish Friendly is run on a going concern basis for the benefit of its current and future members, my expectation is therefore that dissolution would occur only if it were to experience extreme financial distress. In this scenario it is likely that surplus assets would be negligible, rendering academic the dilution of existing members' rights in that scenario.

### Treating customers fairly

4.48 The Scheme is not expected to result in any changes to Scottish Friendly's existing PPFMs. There is not expected to be a materially adverse effect on the benefit security or benefit expectations, and indeed there is expected to be an increase in these over time. Further, I believe that the Scheme is consistent with the requirements to treat customers fairly. Hence, I do not expect the Scheme to lead to with-profits policyholders not being fairly treated.

### Administration

4.49 There will be no change to the administration of existing Scottish Friendly policies as a result of the Scheme.

4.50 The transferring policies will be migrated on to Scottish Friendly's administration systems. Such a transfer carries with it associated risks, but I am satisfied that these will be mitigated through careful planning, appropriate resourcing and detailed systems testing to ensure the successful migration of the policies. I therefore expect there to be minimal impact on existing Scottish Friendly policyholders from an operational and administrative perspective, with no decrease in service standards.

### Policyholder communications

4.51 The regulations governing Part VII transfers require that, unless the Court otherwise orders, all policyholders in all affected companies should be written to in order to inform them of the proposed Scheme. An application is to be made for a waiver from mailing Scottish Friendly's existing policyholders.

4.52 Given that:

- I do not expect the Scheme to have a materially adverse effect on Scottish Friendly's existing with-profits policyholders,
- I do not expect the Scheme to result in a significant dilution of membership rights, and
- policyholders are represented by the delegates, who will be required to approve the Scheme at a Special General Meeting,

I consider that existing with-profits policyholders would derive only limited utility from being notified of the Scheme. In my view, the limited benefit is insufficient justify the effort and expense of writing to all existing policyholders, making such a notification disproportionately expensive. I would therefore support an application being made for a waiver from notifying Scottish Friendly's existing policyholders, provided that the delegates are notified of the Scheme in a timely manner.

### UK's planned withdrawal from the European Union ("Brexit")

4.53 The UK's planned withdrawal from the European Union ("EU") is currently scheduled to occur on or before 31 October 2019. There remains a great deal of uncertainty as to when Brexit may occur and what form it might ultimately take.

4.54 Scottish Friendly has c. 21,000 policyholders who currently reside in the EU but outside of the UK, over 90% of whom are in the Republic of Ireland. Given the lack of agreed Brexit terms there remains uncertainty around "contract continuity", i.e. whether Scottish Friendly will be able to collect premiums and pay benefits for that business after Brexit. Scottish Friendly's working assumption is that it will be permitted to service existing business in EU countries after Brexit. The risk that this is not the case exists regardless of the proposed Scheme.

4.55 Around 1,100 transferring policyholders are believed to currently reside outside of the UK. Given the small number of such policyholders I do not consider that the transfer will lead to a significant increase in risk to Scottish Friendly and its existing policyholders from the perspective of its operations after Brexit.

4.56 Should there be significant developments relating to Brexit that would impact this transaction I will comment on these in my supplementary report in due course.

### Taxation

4.56 It is not expected that there will be any impact on the tax position of existing Scottish Friendly policyholders or funds as a result of the Scheme.

4.57 Confirmations and clearances have been applied for from Her Majesty's Revenue & Customs where appropriate.

# 5 Conclusions

5.1 As set out in the preceding sections of this report, in my opinion, the Scheme is not expected to have a materially adverse effect on:

- the security of benefits for Scottish Friendly's existing with-profits policyholders,
- the benefit expectations for Scottish Friendly's existing with-profits policyholders,
- the balance of risks to which Scottish Friendly's existing with-profits policyholders are exposed,
- the fair treatment of Scottish Friendly's existing with-profits policyholders, and
- the membership rights of Scottish Friendly's existing with-profits policyholders.

5.2 This report and its conclusions apply equally to the Guernsey Scheme and the Jersey Scheme as they do to the Scheme.

Stephen Makin

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**Stephen Makin FFA CERA**
**With-Profits Actuary, Scottish Friendly**

**For and on behalf of Hymans Robertson LLP**
**7 June 2019**

# Appendix A: Documents considered

The following table lists the main documents and analysis supplied to me which I have considered in preparing my report.

| Ref | Document | Author | Version / Date |
|---|---|---|---|
| [1] | The report by the Scottish Friendly Chief Actuary [in draft] | Alan Rankine | June 2019 |
| [2] | The report by the Canada Life Chief Actuary [in draft] | Chris Lewis | May 2019 |
| [3] | The report by the Canada Life With-Profits Actuary [in draft] | Hitesh Shah | 28 May 2019 |
| [4] | The Scheme Report by the Independent Expert [in draft] | Simon Grout | 24 May 2019 |
| [5] | The Scheme of Transfer [in draft] | Hogan Lovells | 24 January 2019 |
| [6] | Scottish Friendly Group ORSA Annual Report | Kim Durniat | 21 January 2019 |
| [7] | Manulife Principles and Practices of Financial Management | Canada Life | March 2018 |
| [8] | The Business Transfer Agreement | Hogan Lovells | June 2018 |
| [9] | Explanatory note on Pillar 2 | Alan Rankine | Recd 13 May 2019 |

# Appendix B: Glossary of terms and abbreviations used

| Term | Meaning |
|---|---|
| BEL | Best Estimate Liabilities |
| BTA | Business Transfer Agreement |
| Canada Life | Canada Life Limited |
| CERA | Chartered Enterprise Risk Actuary |
| FCA | Financial Conduct Authority |
| FFA | Fellow of the Institute & Faculty of Actuaries |
| FSMA | Financial Services and Markets Act 2000 |
| Guernsey Scheme | The proposed transfer of business relating to policyholders resident in Guernsey from Canada Life to Scottish Friendly |
| Hymans Robertson | Hymans Robertson LLP |
| IFoA | Institute and Faculty of Actuaries |
| ISA | Individual Savings Account |
| Jersey Scheme | The proposed transfer of business relating to policyholders resident in Jersey from Canada Life to Scottish Friendly |
| LANMAS | London Aberdeen & Northern Mutual Assurance Society |
| M&A | Mergers and acquisitions |
| Manulife Fund | A ring-fenced with-profits fund in Canada Life |
| Manulife sub-fund | The ring-fenced sub-fund of Scottish Friendly into which the business (including assets and liabilities) of the Manulife Fund will transfer under the Scheme |
| M&GM | Marine & General Mutual Life Assurance Society |
| Mobius Life | Mobius Life Limited |
| ORSA | Own Risk & Solvency Assessment |
| Pioneer | Pioneer Friendly Society |
| PPFM | Principles and Practices of Financial Management |
| PRA | Prudential Regulation Authority |
| Preston Operative | Preston Operative Assurance |
| Rational Shelley | Rational Shelley Friendly Society |
| Royal Standard | Royal Standard Friendly Society |
| Scheme | The proposed transfer of business from Canada Life to Scottish Friendly |
| SCR | Solvency Capital Requirement |
| Scottish Legal | Scottish Legal Life Assurance Society Limited |
| Scottish Friendly | Scottish Friendly Assurance Society Limited |
| Solvency II | Directive 2009/138/EC of the European Parliament and of the European Council, dated 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) |
| WPAA | With-Profits Advisory Arrangement |
| WPC | With-Profits Committee |