Scottish Friendly Assurance Society Ltd Actuarial Function Holder Supplementary Report on the proposed Part VII transfer from Marine & General Mutual Life Assurance Society Ltd

Prepared by: Donald Macleod FFA

1. Summary

1.1. In January 2015, I prepared a report ('the main report') describing the proposed insurance transfer scheme ('the Scheme') as defined in Part VII of The Financial Services & Markets Act 2000 ('FSMA') relating to the transfer of the long-term insurance business of Marine & General Mutual Life Assurance Society Ltd ('M&G') to Scottish Friendly Assurance Society Ltd ('SF'). At that time, I indicated that a Supplementary Report may be prepared prior to the final Court Hearing. This Supplementary Report has been prepared to outline the financial impact of the proposed Scheme as at 31 December 2014, and should be read in association with the main report.

1.2. This Supplementary Report has been prepared for the Board of SF.

1.3. It remains my opinion that:

- The Scheme is not expected to have a materially adverse impact on the security of benefits for existing SF policyholders.
- The Scheme is not expected to have a materially adverse impact on the benefit expectations for existing SF policyholders.
- The Scheme is not expected to have a materially adverse impact on the fair treatment of existing SF policyholders.
- The Scheme is not expected to have a materially adverse impact on the membership rights of existing SF policyholders.
- The administration and management of SF policies is not expected to be adversely impacted by the Scheme.

1.4. I conclude, therefore, that the Scheme does not have a material adverse impact on the security of benefits, benefit expectations, or the fair treatment of SF policyholders.

1.5. This Supplementary Report has been presented to the With Profits Actuary, David Lechmere, who has confirmed that he has read the Supplementary Report and that there is nothing in the report (or in anything else he has seen) which would cause him to change the views expressed in his original report, and that he therefore does not consider necessary to update his original report or issue a supplementary report.

2. Background

2.1. The transfer of business from M&G to SF will take effect by means of an insurance business transfer scheme ('the Scheme') under Part VII of the Financial Services and Markets Act 2000. The Effective Date of the Scheme is expected to be 1 June 2015.

2.2. In this Supplementary Report I have considered the Transfer from the perspective of the policyholders of SF, into which the M&G business will be transferred. My primary consideration is whether the Transfer has any material adverse impact on SF policyholders. I have not considered the Transfer from the perspective of the existing M&G policyholders.

2.3. This Supplementary Report is written for the Board of SF in my capacity as Actuarial Function Holder ('AFH') for the Company, and should be read in conjunction with the main report.

Status and Disclosure

2.4. I am a Fellow of the Institute & Faculty of Actuaries, having qualified in 2005, and hold a certificate issued by the Institute & Faculty of Actuaries to act as a Life Actuary (including with-profits). I have been the AFH for SF since 18 September 2012. I have over 16 years of experience working in the UK life assurance industry.

2.5. I am an employee of SF.

2.6. I do not hold any individual insurance policies with any of the Companies other than as a member of the SF staff defined contribution pension arrangement.

2.7. I can confirm that my personal interests have not influenced me in reaching any of the conclusions detailed in this Supplementary Report.

Other Advice and Opinions

2.8. Mr Simon Grout of Oliver Wyman has been retained by the Boards of the Companies in the capacity of Independent Expert and has been approved as such by all the relevant Regulators. I have read a draft of his Supplementary Report on the terms of the Scheme and considered his conclusions. A copy of this Supplementary Report has also been provided to Mr Grout who has had the opportunity to review various earlier draft versions.

2.9. In addition, I have read the following report in relation to the proposed transfers and considered any impact in relation to the policyholders in M&G prior to the transfer:

- Report of Ms R Johnson "YE14 Balance sheet analysis update" prepared for Mr S Grout

Definitions and Abbreviations

2.12. A list of the definitions and abbreviations that I have used in this document is included in Annex A. Defined terms used but not defined in this Supplementary Report have the same meaning as those used in the Scheme document and the Independent Expert's Report unless otherwise highlighted.

Compliance with Technical Actuarial Standards

2.13. This Supplementary Report has been prepared in accordance with, and complies with, the Technical Actuarial Standards on Reporting, Data, Modelling, Insurance and Transformations issued by the Financial Reporting Council.

Structure of Supplementary Report

2.14. This Supplementary Report is structured as follows:

- Section 3 considers the estimated financial position of SF before and after the Transfer;
- Section 4 sets out the effect of the Scheme on SF policyholders;
- Section 5 sets out my conclusions;
- Annex A lists the abbreviations mentioned in this Supplementary Report;
- Annex B discusses the various reporting underlying the results in this Supplementary Report;
- Annex C shows the detailed Pillar 1 results before and after the transfer.

3. Financial position before and after the transfer

Background

3.1. 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. This calculation is performed on two different bases.

3.2. The first is an assessment of solvency in accordance with existing EU regulatory requirements which broadly takes the difference between assets and the sum of policy liabilities and additional solvency capital to determine if the insurer is adequately capitalised. This calculation is known as Pillar 1.

3.3. The second requires companies to make their own assessment of the amount of capital they need to hold, based on the risks to which the firm is exposed, to ensure that it remains able to meet its liabilities to policyholders in all but the most extreme circumstances. This calculation is referred to as the Individual Capital Assessment (ICA), also known as Pillar 2 and is submitted to the regulators privately (unlike Pillar 1 which is publicly available information).

3.4. Changes are planned to the solvency framework in the EU known as Solvency II. This is expected to replace the existing Pillar 1 and Pillar 2 requirements. The implementation date of Solvency II is 1 January 2016.

3.5. More detail on these reporting bases is provided in Annex B.

Solvency Calculations

3.6. In order to assess whether or not the security of policyholder benefits is materially affected by the Scheme, it is helpful to compare the solvency position of SF before and after the Scheme.

3.7. The Pillar 1 and Pillar 2 solvency ratios provide a useful indicator of the immediate impact of the Scheme on the level of benefit security provided to policyholders.

3.8. The solvency position of SF before and after the transfer has been calculated as at 31 December 2014, based on the reported Pillar 1 position and the calculated Pillar 2 position. Allowance has been made for any material changes since 31 December 2014. The methodologies and assumptions used in the calculations are consistent with those used at 31 December 2014 for Pillar 1 and broadly consistent with those as at 31 December 2014 for Pillar 2. The actual solvency positions at the Effective Date will differ from these estimates, but the following figures are considered to be a fair indication of the impact of the Scheme on the solvency position of SF.

Pillar 1 Position

3.9. The table below shows the Pillar 1 position for SF policyholders before and after the Scheme. Annex C shows the same results in more detail.

SF Pillar 1 result 31 December 2014	Pre transfer	Post transfer
Total Assets	£971.3m	£1,706.3m
Total Liabilities	£786.3m	£1,417.9m
Capital resources	£185.0m	£288.4m
Capital resources available[1]	£183.4m	£286.8m
Capital resources requirement	£109.7m	£202.9m
Excess capital resources	£73.7m	£83.9m
Capital cover	167%	141%

3.10. The figures shown above are gross of existing SF reinsurance arrangements, and are consistent with the PRA Insurance Returns.

3.11. The impact of the transfer is to reduce the capital cover from 167% to 141%, with the excess capital resources increasing from £73.7m to £83.9m.

3.12. These results show that SF is expected to be able to meet its Pillar 1 capital requirements, including the capital requirements in respect of the M&G sub-fund immediately after the Scheme.

3.13. As can be seen in Annex C, when considered in isolation, the solvency position of the SF Main Fund increases from 226% to 260% as a result of the Scheme.

Pillar 2 Position

3.14. The Pillar 2 solvency position for SF policyholders has been calculated before and after the Scheme[2] as at 31 December 2014. The impact of the Scheme is to increase the capital available and to slightly increase the capital cover under Pillar 2. The solvency position post-transfer remains comfortably above SF's risk appetite, and I remain comfortable that the Scheme is not expected to result in a material worsening of the solvency position of SF on a Pillar 2 basis.

Solvency II Position

3.15. SF is currently calculating the solvency position as at 31 December 2014 under the Solvency II basis. It is expected that the change in the solvency position from 31 December 2013 on this basis will be broadly in line with the changes in the solvency position from 31 December 2013 on the pillar 2 basis.

3.16. I remain comfortable the Scheme should not threaten the solvency position of SF on a Solvency II basis, and does not materially adversely affect the security or benefit expectations of SF policyholders.

[1] This represents the total capital resources less a deduction in respect of regulated subsidiaries and the difference between the realistic and statutory value of assets (i.e. the mid/bid spread).

[2] As this report is effectively a publicly available report I have not included the detailed Pillar 2 results in this report, and have confined myself within this report to a description of the position sufficient to support my conclusions. A report showing the impact of the Scheme has been prepared and shared with the Independent Expert, and will be submitted to both the PRA and FCA.

Capital management

3.17. In addition to the regulatory requirements around capital adequacy, SF also has 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 the Own Risk Solvency Assessment.

3.18. I remain confident that the Scheme is not expected to result in these tolerances being breached, or to require the tolerances to be changed.

4. Effect of the Scheme on policyholders

4.1. In the main report, consideration was given to the effect of the proposed Scheme on the existing SF policyholders with respect to the security of their benefits, their benefit expectations, quality of administration, planned communications and other relevant factors.

4.2. It is my opinion that the change in solvency position from 31 December 2013 to 31 December 2014, as outlined in this Supplementary Report, does not invalidate the conclusions drawn in the main report.

4.3. In addition, I do not consider that the proposed Scheme materially impacts the risk profile of the SF business.

4.4. Therefore, I remain confident that the proposed Scheme does not materially affect the security of their benefits, their benefit expectations, quality of administration, planned communications and other relevant factors.

5. Conclusion

5.1. I have produced this Supplementary Report in my role as Actuarial Function Holder of SF to set out the impacts of the Part VII Transfer on the policyholders of SF.

5.2. In assessing the potential impacts of this Scheme, I have given due consideration to the effects of the planned Transfer on the security and benefit expectations of the policyholders.

5.3. I conclude that the interests of the policyholders in SF prior to and remaining post Transfer will not be materially adversely affected by the implementation of the Scheme. In particular, I am satisfied that:

- The Scheme will not materially adversely affect the security or benefit expectations of policyholders compared to the status quo; and
- The terms of the Scheme do not introduce any material conflict with the manner in which any of the business involved in the Transfer is currently being managed.

D A Macleod FFA
Actuarial Function Holder (SF)
15 May 2015

Annex A – Abbreviations used in Supplementary Report

AFH	Actuarial Function Holder
CRR	Capital Resources Requirement
CWP	Conventional with-profits
EU	European Union
FCA	Financial Conduct Authority
FFA	Fellow of the Institute & Faculty of Actuaries
FIA	Flexible Income Annuity
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
HMRC	HM Revenue and Customs
ICA	Individual Capital Assessment
ICG	Individual Capital Guidance
ISA	Individual Savings Account
LANMAS	London Aberdeen & Northern Mutual Assurance Society
LTICR	Long-Term Insurance Capital Requirement
M&G	Marine & General Mutual Life Assurance Society Ltd
OEIC	Open Ended Investment Company
PPFM	Principles and Practices of Financial Management
PRA	Prudential Regulation Authority
SFAM	Scottish Friendly Asset Managers Limited
SFIS	Scottish Friendly Insurance Services Limited
SLIS	SL Insurance Services Limited
UWP	Unitised with-profits
WPA	With-profits Actuary
WPICC	With-Profits Insurance Capital Component

Annex B – Overview of valuation bases used in this Supplementary Report

Described below are the key features of the valuation bases discussed within this Supplementary Report and used to understand the impact on policyholders.

Pillar 1

Pillar 1 is based on existing European Union regulatory requirements. Assets are taken at market value and reserves are set up to cover a fund's liabilities. These liabilities (which for the base Pillar 1 calculations exclude non-guaranteed discretionary payments) are valued using assumptions that include prudent margins. Solvency capital, expressed as a percentage of reserves and of sums at risk, is required in addition to the reserves. This calculation is commonly referred to as the "regulatory peak".

Companies such as SF which have a with-profits fund in excess of £500m are also required to report Pillar 1 results on a realistic, market consistent, basis for their with-profits fund business. This calculation allows more appropriately for the nature of policyholder benefits on with-profits contracts. If the result using this calculation is more onerous than the regulatory peak, an adjustment, called the With-Profits Insurance Capital Component (WPICC), is made to the regulatory peak capital requirements equal to the difference.

Pillar 2

Pillar 2 requires that each company undertakes its own Individual Capital Assessment (ICA). Liabilities are valued using best estimate assumptions with no deliberate margins. The capital requirements are based on an analysis of the various risks affecting the company (including market, credit, insurance, operational and liquidity risk), the results of various stress and scenario tests, and an overall assessment of the amount and type of capital required to meet those risks.

Under Pillar 2, companies can set their own risk tolerance which must be based on a confidence level at least as high as the regulator's minimum standard of a 99.5% solvency confidence level over one year. The ICA analysis is regularly reviewed by the regulators. The regulator may issue Individual Capital Guidance (ICG) if it feels that the ICA is insufficient to meet the minimum 99.5% confidence level.

Solvency II

The regulatory capital regime for insurers is due to be replaced by a new European Directive, referred to as Solvency II. The Directive framework has been agreed and the implementing measures are now being drafted, but the precise rules for assessing solvency on this basis are not yet known.

Although the general approach for Solvency II has been agreed, there are some aspects of the new regime that are yet to be determined. The Companies involved in the Scheme are likely to take an approach similar to that for Pillar 2.

Annex C – Impact of Scheme on pillar 1 solvency position

Section 3.9 illustrated the impact of the Scheme on the pillar 1 solvency position of SF. This annex seeks to provide further detail around this impact.

Solvency position prior to transfer

The pillar 1 solvency position of SF prior to the Scheme is outlined below (all figures in £m):

	SF main fund	LANMAS	RS	SLL	Aggregate SF before transfer
Regulatory Balance Sheet					
Assets	687.3	24.4	10.6	100.7	823.0
Liabilities	555.1	16.0	6.9	61.6	639.6
LTICR	27.6	0.4	0.3	2.2	30.5
Regulatory Excess Capital	104.6	8.0	3.4	36.9	152.9
Capital Resource Available	132.2	8.4	3.7	39.1	183.4
Realistic Balance Sheet					
Assets	420.7	15.3	8.6	77.8	522.5
With Profits Benefit Reserve	304.2	12.1	7.1	42.8	366.1
Cost of Guarantees & options	21.9	-	-	3.5	25.4
Planned Enhancements	-	3.1	0.7	26.9	30.7
Planned Deductions	-5.5	-	-	-	-5.5
Smoothing Costs	8.1	-	0.6	0.2	8.9
Other Liabilities	-	-	-	0.4	0.4
Current Liabilities	13.1	0.2	0.2	4.1	17.6
Total Liabilities	341.8	15.4	8.6	77.9	443.6
RCM	5.2	-	-	-	5.2
Realistic Excess Capital	73.7	-	-	-	73.7
Working Capital	78.9	-	-	-	78.9
WPICC	30.9	8.1	3.4	37.0	79.2
CRR	58.5	8.5	3.7	39.2	109.7

The figures are calculated as at 31 December 2014, and are shown net of existing SF reinsurance arrangements.

The solvency position gross of existing SF reinsurance arrangements is summarised below (all figures in £m):

Total Assets	971.3
Total Liabilities	786.3
Capital Resources	185.0
Capital Resources Available	183.4
CRR	109.7
Excess Capital Resources	73.7
Capital Cover	167%

Solvency position post transfer

The pillar 1 solvency position of SF after the Scheme is outlined below (all figures in £m):

	SF main fund	LANMAS	RS	SLL	M&G	Aggregate SF after transfer
Regulatory Balance Sheet						
Assets	1,033.3	24.4	10.6	100.7	389.0	1,558.0
Liabilities	896.7	16.0	6.9	61.6	290.0	1,271.2
LTICR	31.3	0.4	0.3	2.2	37.0	71.1
Regulatory Excess Capital	105.3	8.0	3.4	36.9	62.0	215.7
Capital Resource Available	136.6	8.4	3.7	39.1	100.0	286.8
Realistic Balance Sheet						
Assets	431.1	15.3	8.6	77.8	346.0	878.8
With Profits Benefit Reserve	304.2	12.1	7.1	42.8	280.0	646.2
Cost of Guarantees & options	21.9	-	-	3.5		25.4
Planned Enhancements	-	3.1	0.7	26.9	66.0	96.7
Planned Deductions	-5.5	-	-	-		-5.5
Smoothing Costs	8.1	-	0.6	0.2		8.9
Other Liabilities	-	-	-	0.4		0.4
Current Liabilities	13.1	0.2	0.2	4.1		17.6
Total Liabilities	341.8	15.4	8.6	77.9	346.0	789.7
RCM	5.2	-	-	-	-	5.2
Realistic Excess Capital	84.1	-	-	-	-	83.9
Working Capital	89.3	-	-	-	-	89.1
WPICC	21.2	8.1	3.4	37.0	62.0	131.8
CRR	52.5	8.5	3.7	39.2	99.0	202.9

The figures are calculated as at 31 December 2014, and are shown net of existing SF reinsurance arrangements.

The solvency position gross of existing SF reinsurance arrangements is summarised below (all figures in £m):

Total Assets	1,706.3
Total Liabilities	1,417.9
Capital Resources	288.4
Capital Resources Available	286.8
CRR	202.9
Excess Capital Resources	83.9
Capital Cover	141%