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**Supplementary report of the Independent Expert on the transfer of the long term business of Paternoster UK Limited to Rothesay Life Limited**

Prepared by:

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## 1. INTRODUCTION

- 1.1. I have been appointed by Paternoster UK Limited (“PUKL”) and Rothesay Life Limited (“RLL”) to report, pursuant to Section 109 of FSMA, in the capacity of the Independent Expert, on the terms of the proposed scheme providing for the transfer of the long term business from PUKL to RLL.
- 1.2. The Scheme will be presented to the Court for sanction under Section 111 of FSMA.
- 1.3. The purpose of this supplementary report is to update my previous report entitled “Report of the Independent Expert on the transfer of the long-term insurance business of Paternoster UK Limited to Rothesay Life Limited” (“my report” or “my main report”) dated 19 July 2011.
- 1.4. This supplementary report considers whether the conclusions reached in my main report remain valid in light of the updated financial information received and other relevant changes and events that have occurred since my main report was written.
- 1.5. This supplementary report should be read in conjunction with my main report which considers the consequences of the Scheme for the policyholders of PUKL and RLL.
- 1.6. My appointment as Independent Expert has been approved by the Financial Services Authority (the “FSA”), and the FSA has approved the form of my main report.
- 1.7. This supplementary report and my main report have been prepared under the terms of the guidance set out in Chapter 18 of the Supervision Manual contained in the FSA Handbook. Both reports also comply with the relevant Technical Actuarial Standards (“TAS”), namely TAS-R - Reporting Actuarial Information, TAS-D - Data, Insurance TAS and Transformations TAS.
- 1.8. In reporting on the Scheme as the Independent Expert, I recognise that I owe a duty to the Court to assist on matters within my expertise. This duty overrides any obligation to PUKL and RLL. I confirm that I have complied with this duty.
- 1.9. I am aware of the requirements regarding experts set out in Part 35 of the Civil Procedure Rules, this Practice Direction and the Protocol for Instruction of Experts to give Evidence in Civil Claims.
- 1.10. The limitations listed in Section 1 of my main report apply equally to this report. The documentary evidence to which I have had access in preparing this report is listed in Appendix 3.

## 2. THE SCOPE OF THIS SUPPLEMENTARY REPORT

- 2.1. My main report was finalised for the Court on 19 July 2011 and in Section 8 of my main report I listed my conclusions regarding the effect of the Scheme on the various groups of affected policyholders.
- 2.2. This supplementary report has been written to reconsider the conclusions in my main report in light of events since the finalisation of that report and to address any specific issues that may have arisen in the intervening period.
- 2.3. In particular, in this supplementary report, I consider:
  - The updated financial position of PUKL and RLL before and after the implementation of the Scheme, based on estimated financial information as at 30 September 2011;
  - Significant changes made to the business of RLL and PUKL since my main report was written, including the PUKL transactions that were described as current initiatives in Section 5 of my main report and which have since been implemented; and
  - Issues raised by policyholders since the distribution of the communications pack, which contained a summary of my main report, to policyholders in October 2011.

### 3. THE FINANCIAL POSITION AS AT 30 SEPTEMBER 2011

- 3.1. As described in Section 2 of my main report, companies are currently required to assess their solvency under two regimes: Pillar I and Pillar II.

#### Pillar I

- 3.2. In the appendices of my main report I summarised the Pillar I financial positions of RLL and PUKL as at 31 December 2010 prior to the Scheme, and the estimated Pillar I financial position of RLL as if the Scheme had been implemented on this date.
- 3.3. I include these tables in Appendices 1 and 2 to this supplementary report, along with tables containing updated figures as at 30 September 2011. I draw out some key conclusions from these tables below.

#### Prior to the implementation of the Scheme

- 3.4. Prior to the implementation of the Scheme, the overall Pillar I solvency positions of both RLL and PUKL have changed since 31 December 2010. The tables in Appendix 1 show that:
- RLL's excess assets as a percentage of Pillar I liabilities decreased from 16% to 13% between December 2010 and September 2011, and coverage of the Capital Resources Requirement ("CRR") decreased from 350% to 295%.
  - PUKL's excess assets as a percentage of liabilities increased from 11% to 12% between December 2010 and September 2011 and CRR coverage increased from 259% to 286%.

#### After the implementation of the Scheme

- 3.5. The pro-forma Pillar I solvency position of RLL as at 30 September 2011 is marginally stronger than the pro-forma Pillar I solvency position as at 31 December 2010. The tables in Appendix 2 show that:
- RLL's projected (post-transfer) excess assets as a percentage of Pillar I liabilities remain unchanged between December 2010 and September 2011 at 12%.
  - The post-transfer CRR coverage increased from 283% to 288%.

#### The effect of the Scheme

- 3.6. Based on the Pillar I financial information as at 31 December 2010, as discussed in my main report, the Scheme leads to a deterioration in the various ratios for RLL and an improvement for PUKL. The same effect is seen when looking at the 30 September 2011 figures, although the magnitude of the changes is smaller.
- 3.7. As stated above, there is an overall improvement in the projected, post-transfer solvency position compared to that based on the financial information as at 31 December 2010.

#### Pillar II

- 3.8. I have been provided with updated Pillar II information for PUKL and RLL pre-transfer, and the projected combined Pillar II position of the company post-transfer as at 30 September 2011. There has been very little change in the solvency position of PUKL and RLL, before and after the proposed transfer, on a Pillar II basis.

#### Conclusion

- 3.9. I am satisfied that, based on the financial information as at 30 September 2011, the conclusions in Section 8 of my main report still hold.

## 4. SIGNIFICANT BUSINESS CHANGES SINCE MY MAIN REPORT

- 4.1. In this section I summarise the significant business changes that have taken place within PUKL and RLL since my original report was produced and discuss them in the context of the proposed Scheme.

### Longevity swap agreements

- 4.2. RLL and PUKL both entered into longevity swap agreements with RGA in July 2011. Under these agreements RLL and PUKL pay pre-determined amounts based on the expected claims experience of a defined block of annuity business, and in return, receive amounts from RGA that reflect the actual claims experience on this block of business. The longevity risk associated with this business is thus passed to RGA and the mathematical reserves held in respect of longevity risk are therefore released.
- 4.3. £0.9 billion of PUKL annuity liabilities and £0.2 billion of RLL annuity liabilities were covered by this agreement which released £34 million and £11 million respectively of mathematical reserves. There was no effect on the Pillar I asset values in either company.
- 4.4. The longevity swap arrangement strengthened the Pillar II position of both PUKL and RLL via a decrease in the longevity risk capital requirement. This was partially offset by an increase in the counterparty default capital requirement and an increase in best estimate liabilities as a result of the premiums payable for the longevity swap.

### Secured funding arrangement and changes to the Total Return Swap (“TRS”)

- 4.5. PUKL entered into a series of secured funding transactions in July 2011 with a total value of £1 billion. These transactions consisted of a repurchase (“repo”) agreement and a TRS which were entered into with the same counterparty.
- 4.6. Under the repo agreement, PUKL purchased £1 billion of assets from the counterparty at the outset which will be repurchased by the counterparty in three separate tranches at pre-determined times. The custodian to this agreement is the Bank of New York Mellon, which is currently rated AA with a stable outlook by Standard & Poor’s.
- 4.7. The agreement is over-collateralised as the market value of the assets transferred to PUKL at the outset was greater than £1 billion, and the extent of the over-collateralisation reflects the type, and hence credit risk, of the transferred assets. The counterparty must top up the underlying assets via margin payments whenever their aggregate market value falls below a certain threshold.
- 4.8. In addition, the existing TRS held by PUKL was partially replaced with two additional TRSs with different counterparties.
- 4.9. As a result of the secured funding arrangement and changes to the existing TRS, the PUKL Pillar 1 valuation rate of interest was increased with a subsequent release of mathematical reserves. The combined impact of the secured funding arrangement and the changes made to PUKL’s TRS portfolio was a release of £18 million of mathematical reserves.
- 4.10. The secured funding arrangement and changes to the TRS strengthened PUKL’s Pillar II position via an increase in the discount rate but this was partially offset by an increase in the counterparty default capital requirement.

### Business written by RLL

- 4.11. RLL wrote a block of business in September 2011 which is similar to the existing business of both companies and is small at less than 4% of the combined RLL and PUKL liabilities. It has been estimated that the capital strain resulting from this acquisition will reduce the RLL Pillar I excess assets by £10 million and the Pillar II excess assets by £5 million.

### Transactions since 30 September 2011

- 4.12. Since 30 September 2011 RLL has entered into a longevity swap agreement with the US company, Prudential Financial. This deal is very similar to the RGA agreement described above but it is smaller in size.
- 4.13. As with the RGA agreement, this deal will have a positive effect on the Pillar I and Pillar II financial positions of RLL.

### Market movements

- 4.14. The market movement that would potentially have the most significant adverse effect on PUKL and RLL is a general fall in the yields available on fixed interest assets.
- 4.15. There have been some significant changes in financial markets since the finalisation of my main report including a general fall in the yields available on fixed interest assets. The effects of this volatility are reflected in the financial information as at 30 September 2011 as provided in Section 3. I have considered the likely effect of any further volatility on the financial strength of PUKL and RLL before the transfer and RLL after the transfer and whether there are any further implications of the proposed transfer for policyholders.
- 4.16. The matching strategies employed by both companies ensure that the effects of such market volatility are reduced, and, although there is a subsequent reduction in the Pillar I excess assets of the companies before and after the proposed transfer, the relative financial strengths of PUKL and RLL pre-transfer and RLL post-transfer remain relatively unchanged and are similar to those observed as at 31 December 2010 and as at 30 September 2011.
- 4.17. Therefore, after a fall in the general yields available on fixed interest assets, the conclusions reached in Sections 5 and 6 of my main report and in Section 7 of this supplementary report remain valid.

### Other impacts on the excess assets in 2011

- 4.18. In the period between 31 December 2010 and 30 September 2011, an expense overrun has occurred in RLL in respect of new business written. As a result the Pillar 1 excess asset position of RLL has reduced over this period by £13 million.
- 4.19. An expense overrun has occurred in PUKL over this period in respect of one-off costs associated with the restructuring of the business following the acquisition of PUKL by RLL. This has resulted in a reduction in the Pillar I excess assets of PUKL of £8 million.
- 4.20. A revision of the mortality basis on a block of RLL business resulted in a release of £10 million of mathematical reserves.

### Future transactions

- 4.21. I have had discussions with senior management of RLL and PUKL regarding a number of potential transactions which the companies may enter into prior to the transfer and I have reviewed the effect that these potential transactions could have on both companies and on the combined, post-transfer RLL company.
- 4.22. These transactions would be entered into in the normal course of business and would be subject to the normal controls, profitability and capital efficiency guidelines as required by the appropriate Board. Although there is the potential for such transactions to reduce the excess assets in RLL (at the time at which the transactions occur), the capital policy described in Section 5 of my main report will be in force and will require additional capital to be provided if needed to support the new business. I am satisfied that, should these transactions take place on substantially the same terms as management have indicated to me, the conclusions made in Sections 5 and 6 of my main report, and in Section 7 of this supplementary report remain valid.

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## 5. REGULATORY CHANGES

### Solvency II

- 5.1. There have been no material changes to the draft Solvency II regulations which would change the conclusions contained in Section 7 of my main report. As I stated there, given the similarities between PUKL, RLL and the merged, post-transfer RLL, it seems likely that any subsequent changes to the Solvency II regime would affect the financial position of these companies in a similar way.
- 5.2. The latest version of the Omnibus II text proposes a revised Solvency II implementation date of January 2014. The intention to postpone the implementation date for UK insurers has been confirmed recently by the FSA via comments on its website.

### Other regulations

- 5.3. The FSA published a consultative paper in July 2011 on the subject of 'liquidity swaps', which it defines as transactions in which insurers swap liquid for illiquid assets, typically with banks as the swap counterparty. The paper raises specific concerns about conflicts of interest that are likely to arise in relation to intra-group liquidity swaps and states that such transactions should, as a general principle, be avoided. Intra-group liquidity swaps are held by both RLL and PUKL.
- 5.4. In October 2011 the Council of the European Union published its position with respect to draft legislation aimed at increasing transparency and reducing counterparty risk associated with over-the-counter ("OTC") derivatives. The draft legislation calls for the clearing of OTC derivatives through central counterparties and the reporting of all derivative holdings to central data centres. Both RLL and PUKL currently hold OTC derivatives.
- 5.5. The issues faced by PUKL and RLL in respect of these proposed regulatory changes will be similar to those faced by the combined post-transfer RLL and therefore will need to be dealt with whether or not the transfer goes ahead. Hence there is no impact on the conclusions in my main report.

## 6. OTHER ISSUES

### Policyholder correspondence

- 6.1. I have been provided with the correspondence from policyholders received by PUKL and RLL in connection with the transfer up until 14 November 2011. There have been relatively few such enquiries. Where appropriate I have responded directly to the policyholders concerned.

### Policyholder options and guarantees

- 6.2. One particular scheme, currently within PUKL, has a guarantee provided by a third party which may cease to have effect as a result of the proposed transfer.
- 6.3. Senior management of RLL have been in discussions with the trustees of this scheme and have, to the satisfaction of the trustees, arranged for an alternative guarantee to be provided by a third party.
- 6.4. On the basis that such a guarantee is provided, I am satisfied that the members of this pension scheme will not be materially affected by the change in provider of the guarantee and, as it is not RLL's capital supporting the guarantee, that there will be no effect on the other policyholders concerned in the proposed transfer.
- 6.5. One policyholder enquiry related to the effect of the proposed transfer on the security of a particular pension scheme and, in particular, on its option, in certain specific circumstances, to surrender.
- 6.6. When considering the impact of the Scheme on, and the fair treatment of, the policyholders of both PUKL and RLL, I have specifically considered the options, guarantees and other features contained within the various policies written by PUKL and RLL. All such options, guarantees, and special features will be unchanged by the transfer except, in the case of such PUKL policies, to reference the post-transfer RLL where appropriate.
- 6.7. In Section 3 of this report and in Sections 5 and 6 of my main report, I describe the financial strength and excess asset positions of the post-transfer RLL relative to PUKL and the pre-transfer RLL. Having considered these, I am satisfied that the PUKL and RLL policyholders with options and/or guarantees attached to their policies will not have the security of their benefits materially adversely affected by the transfer.

### Policyholder charges

- 6.8. I have also reviewed the details regarding charges which RLL has granted to certain policyholders and which are lodged at Companies House.
- 6.9. One such charge is over an account containing an amount that represents the present value of fees payable by RLL to a particular reinsurer over the term of the reinsurance contract. This present value is small compared to the excess assets in the post-transfer RLL (and will reduce over time) and has an insignificant effect on the financial strength of RLL.
- 6.10. I understand that the other accounts over which charges have been granted currently contain only nominal sums. These have been established as part of a structure which allows RLL, in certain circumstances, to secure assets in respect of premiums which may become due to it from policyholders.
- 6.11. I am satisfied that the existence of these charges has no material adverse implications for the policyholders concerned in the Scheme.

## 7. CONCLUSIONS

- 7.1. I have reviewed the Pillar I and Pillar II positions of PUKL and RLL based on updated financial information as at 30 September 2011 as described above. I have also been provided with an estimate of the Pillar I and Pillar II financial positions of RLL assuming the Scheme had been implemented on this date.
- 7.2. The financial figures as at 30 September 2011 have not been subject to external audit as they are not part of an external reporting cycle. However, these figures have been compiled by the actuarial departments of PUKL and RLL and subject to substantial review and subsequent approval by the relevant AFHs. I have discussed the updated financial positions, on both a Pillar I and a Pillar II basis, with the senior management and AFHs of PUKL and RLL.
- 7.3. I am therefore comfortable with relying on this updated financial information to assess whether the conclusions given in my main report still hold.
- 7.4. I am satisfied that the conclusions from my main report remain unchanged and that the implementation of the Scheme will not have a material adverse effect on:
- The security of benefits of the policyholders of PUKL and RLL;
  - The benefit expectations of the policyholders of PUKL and RLL; or
  - The service standards and governance received by the PUKL and RLL policies.



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28 November 2011

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## APPENDIX 1 – SELECTED FINANCIAL INFORMATION BEFORE THE IMPLEMENTATION OF THE SCHEME

The figures in the tables below show the Pillar I financial positions of RLL and PUKL as at 31 December 2010 and as at 30 September 2011. The 31 December 2010 RLL figures have been taken from the externally audited and Board approved 2010 year end FSA Returns. The 31 December 2010 PUKL figures are based on the equivalent FSA Returns but have been amended to reflect significant changes to the PUKL financial position that occurred after 31 December 2010.

### 1. Pre-transfer Pillar I positions as at 31 December 2010

Pre-Transfer		£m	
31 December 2010		RLL Total	PUKL Total
Assets		1,190	3,322
Liabilities	Reserves	710	2,905
	Other liabilities	317	90
	<b>Total liabilities</b>	<b>1,027</b>	<b>2,995</b>
Excess Assets		162	326
CRR		46	126
<b>Pillar I excess assets as % of total liabilities</b>		<b>16%</b>	<b>11%</b>
<b>Coverage for CRR</b>		<b>350%</b>	<b>259%</b>

### 2. Pre-transfer Pillar I positions as at 30 September 2011

Pre-Transfer		£m	
30 September 2011		RLL Total	PUKL Total
Assets		1,423	3,464
Liabilities	Reserves	916	3,037
	Other liabilities	346	51
	<b>Total liabilities</b>	<b>1,262</b>	<b>3,089</b>
Excess Assets		161	375
CRR		55	131
<b>Pillar I excess assets as % of total liabilities</b>		<b>13%</b>	<b>12%</b>
<b>Coverage for CRR</b>		<b>295%</b>	<b>286%</b>

Note for both tables: Assets = Long Term Fund assets + Shareholders' Fund net assets and excess assets do not take into account the CRR.

## APPENDIX 2 – SELECTED FINANCIAL INFORMATION AFTER THE IMPLEMENTATION OF THE SCHEME

The figures in the tables below show the pro forma Pillar I positions of RLL as at 31 December 2010 and as at 30 September 2011, assuming the transfer had taken place on these dates.

### 1. Post-transfer Pillar I position as at 31 December 2010

Post-Transfer		£m
31 December 2010		RLL Total
Assets		4,511
Liabilities	Reserves	3,615
	Other liabilities	408
	<b>Total liabilities</b>	<b>4,023</b>
Excess Assets		488
CRR		173
<b>Pillar I excess assets as % of total liabilities</b>		<b>12%</b>
<b>Coverage for CRR</b>		<b>283%</b>

### 2. Post-transfer Pillar I position as at 30 September 2011

Post-Transfer		£m
30 September 2011		RLL Total
Assets		4,887
Liabilities	Reserves	3,953
	Other liabilities	397
	<b>Total liabilities</b>	<b>4,350</b>
Excess Assets		536
CRR		186
<b>Pillar I excess assets as % of total liabilities</b>		<b>12%</b>
<b>Coverage for CRR</b>		<b>288%</b>

Note for both tables: Assets = Long Term Fund assets + Shareholders' Fund net assets and excess assets do not take into account the CRR.

## APPENDIX 3 – KEY SOURCES OF DATA

In writing this report, I relied upon the accuracy of certain documents and spreadsheets provided by RLL and PUKL. These included, but were not limited to, all the documents listed in Appendix 5 of my main report, and the following:

- Restated financial positions for both RLL and PUKL as at 30 September 2011.
- RLL updated AFH report on the proposed transfer entitled “Report on Proposed Part VII Transfer from Paternoster UK Limited to Rothesay Life Limited, Updated report by the Actuarial Function Holder of Rothesay Life Limited” 18 November 2011.
- PUKL updated AFH report on the proposed transfer entitled “Report on Proposed Part VII Transfer from Paternoster UK Limited to Rothesay Life Limited, Updated report by the Actuarial Function Holder of Paternoster UK Limited” 18 November 2011.
- Documents describing the term and structure of the longevity swaps.
- Documents describing the term and structure of the secured funding arrangement.
- E-mails from RLL and PUKL dated 10/10/2011 and 20/10/2011 providing further information about the changes in the Pillar I and Pillar II financial information as a result of the various transactions and changes since the 2010 year end numbers.
- Policyholder correspondence.