



**Report of the Independent Expert on the transfer of the long-term insurance
business of Paternoster UK Limited to Rothesay Life Limited**

Prepared by:

Oliver Gillespie FIA

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1. INTRODUCTION

The Independent Expert

- 1.1. When an application is made to the High Court (“the Court”) for an order to sanction the transfer of long-term insurance or reinsurance business from one insurer to another, the application is subject to Part VII of the Financial Services and Markets Act 2000 (“FSMA”) and approval by the Court under Section 111. FSMA requires the application to be accompanied by a report on the terms of the Scheme by an Independent Expert.
- 1.2. 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 insurance business of PUKL to RLL.
- 1.3. The purpose of this report is to review the proposed transfer of the long-term business from PUKL to RLL and, in particular, to consider the impact of the proposed transfer on the security of the benefits and the benefit expectations of the existing long-term insurance policyholders of PUKL and RLL.
- 1.4. In this report (“my report”) I refer to this proposed scheme as “the Scheme” or “this Scheme” and throughout the remainder of this report, these terms are used to cover all the proposals included in the scheme of transfer, including any documents referred to therein relating to the proposed implementation and operation of the scheme of transfer.
- 1.5. The Scheme will be presented to the Court for sanction under Section 111 of FSMA.

The scope of my report

- 1.6. My terms of reference have been reviewed by the Financial Services Authority (“FSA”) and are set out in Appendix 6.
- 1.7. My report has been prepared under the terms of the guidance set out in Chapter 18 of the Supervision Manual contained in the FSA Handbook.
- 1.8. My report considers the consequences of the Scheme for the policyholders of PUKL and RLL.
- 1.9. 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.
- 1.10. 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.
- 1.11. As far as I am aware, there are no matters which I have not taken into account in undertaking my assessment of the Scheme and in preparing my report, but which nonetheless should be drawn to the attention of policyholders in their consideration of the terms of the Scheme.
- 1.12. I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.
- 1.13. My report does not consider alternative schemes.

Qualifications and disclosures

- 1.14. I am a Fellow of the Institute and Faculty of Actuaries having qualified in 1999 and hold a certificate issued by the Institute and Faculty of Actuaries to act as a Life Actuary (including with-profits).

- 1.15. I am a Principal of Milliman Limited (“Milliman”) and I am based in its UK life insurance practice. My experience in the UK life insurance industry includes a number of Actuarial Function Holder, Independent Expert and expert witness roles.
- 1.16. My appointment as the Independent Expert has been approved by the FSA in a letter dated 1 April 2011 to PUKL.

Limitations

- 1.17. This report, and any extract or summary thereof has been prepared particularly for the use of the bodies or persons listed below:
- The Court;
 - The Directors and senior management of RLL;
 - The Directors and senior management of PUKL;
 - The FSA or any other governmental department or agency having responsibility for the regulation of insurance companies in the UK; and
 - The professional advisors of any of the above.
- 1.18. In accordance with the legal requirements under FSMA, copies of my report may be made available to the policyholders of RLL and PUKL and other interested parties.
- 1.19. In preparing my report, I have had access to certain documentary evidence provided by RLL and PUKL, the key elements of which are listed in Appendix 5. I have also had access to, and discussions with, senior management of RLL and PUKL. Much of the information listed in Appendix 5 has been subject to formal external audit and my conclusions depend on the substantial accuracy of this information without independent verification. I have considered, and am satisfied with, the reasonableness of this information based upon my own experience across the industry.
- 1.20. This report must be considered in its entirety as individual sections, if considered in isolation, may be misleading. Draft versions of this report should not be relied upon for any purpose. I have provided a summary of my report for inclusion in the policyholder circular (and, where relevant, distribution to any persons requesting a copy of it) and, other than this, no summary of my report may be made without my express consent.
- 1.21. This report has been prepared by Milliman consultants on an agreed basis for RLL and PUKL in the context of the Scheme and must not be relied upon for any other purpose. No liability will be accepted by Milliman, or me, for any application of my report for a purpose for which it was not intended nor for the results of any misunderstanding by any user of any aspect of the report. In particular, no liability will be accepted by Milliman or me under the terms of the Contracts (Rights of Third Parties) Act 1999.

Technical Actuarial Standards (“TAS”)

- 1.22. The following TAS apply to this report:
- TAS (R) – Reporting Actuarial Information;
 - TAS (D) – Data;
 - Insurance TAS; and
 - Transformations TAS (all principles applied).
- 1.23. This report complies with all the TAS listed above.

2. GENERAL CONSIDERATIONS OF THE INDEPENDENT EXPERT

Introduction

- 2.1. I have compiled my report in accordance with Chapter 18 of the Supervision Manual of the FSA Handbook.
- 2.2. Under FSMA, the concept of treating customers fairly (“TCF”) should be applied. To ensure that customers are treated fairly in the future, it is necessary to establish the ways in which customers have been treated in the past. From the policyholders’ perspective, the successful implementation of the Scheme must be on the basis that their benefits and fair treatment are not materially adversely affected.
- 2.3. I need to consider the terms of the Scheme generally and how the different groups of policyholders are likely to be affected by the Scheme and, in particular:
- The effect of the Scheme on the security of the policyholders’ contractual rights, including the likelihood and potential effects of the insolvency of the insurer; and
 - The likely effects of the Scheme on the benefit expectations of policyholders.
- 2.4. As described in Section 3 of this report, two life companies are involved in the Scheme, each with a different mix of business.
- 2.5. The type of policy held by a policyholder will be a key determinant of the risks to which the policyholder is exposed. Other than this, the key determinants will be the characteristics of the company in which the policy is held – for example:
- Size of company;
 - Amount of capital held, other calls on that capital and capital support currently available to the company;
 - Investment strategy;
 - Mix of business written;
 - Company strategy – e.g. open or closed to new business, acquisitions strategy; and
 - Operational risks, reinsurance, governance, tax etc.
- 2.6. Some of these risks are company specific, for example risks arising from the particular mix of business written or the company strategy, and some are common to various different groups of policyholders across the companies subject to the Scheme.

The structure of my report

- 2.7. Section 3 of this report provides some background to RLL and PUKL.
- 2.8. Section 4 summarises the key aspects of the Scheme.
- 2.9. In Sections 5 and 6, I consider the issues arising from the Scheme in relation to the policyholders of PUKL and RLL respectively.
- 2.10. Section 7 covers some further aspects of the Scheme and my conclusions are in Section 8.

Security of policyholder benefits

- 2.11. As part of my role as Independent Expert for the Scheme, I need to consider the security of policyholder benefits, that is the likelihood that policyholders will receive their guaranteed benefits when these are due.

- 2.12. In considering and commenting upon policyholder security, I shall consider primarily policyholders' guaranteed benefits and as appropriate their reasonable benefit expectations. The amount by which the long-term insurance fund assets exceed the long-term insurance fund liabilities (including the mathematical reserves) provides security for guaranteed benefits. Security is also provided by the margins for prudence in the assumptions used to calculate the long-term insurance fund liabilities and by the shareholder capital.

Treating customers fairly ("TCF")

- 2.13. As Independent Expert for the Scheme, I need also to consider the proposals in the context of the FSA's TCF regime and in particular the effect on policyholders' benefit expectations.
- 2.14. This involves consideration of areas where discretion is involved on behalf of the relevant insurance company with regard to the management, service and governance standards applied.

The current UK regulatory regime

- 2.15. Under current UK regulations, UK shareholder owned life insurance companies must maintain separate funds in order to segregate the assets and liabilities attributable to shareholders and policyholders: the shareholders' fund ("SHF"); and the long-term insurance business fund ("LTF").
- 2.16. The LTF represents the assets and liabilities of the long-term insurance contracts issued by the insurance company. The SHF represents assets and liabilities not allocated to the long-term insurance business. The SHF is available to provide support for the LTF and, in particular, can be used to cover the capital requirements of a particular reporting regime.
- 2.17. Financial services in the UK are regulated by the FSA. The primary objective of the regulator is to ensure that insurance companies remain solvent and most of the reporting requirements for life insurers are aimed at demonstrating solvency. At the 2004 year end the FSA introduced a risk based capital framework under which companies are required to assess solvency under two regimes called Pillar I and Pillar II.

Pillar I

- 2.18. Under Pillar I, assets are, broadly speaking, valued at market value and are subject to various admissibility criteria. Reserves for non-profit policies are calculated on a single basis which includes some margins for prudence. In addition to holding these reserves to cover future liabilities, companies must hold further amounts of capital to cover themselves against adverse deviations in future experience and one-off shocks to investment performance. The overall capital requirement under the Pillar I regime is called the Capital Resources Requirement ("CRR") and has a minimum of the Base Capital Resources Requirement ("BCRR") (€3.5 million as at 31 December 2010).
- 2.19. The Long-Term Insurance Capital Requirement ("LTICR") and the Resilience Capital Requirement ("RCR") are elements of the CRR.

Pillar II

- 2.20. The capital that must be held under Pillar II is an amount set by the Individual Capital Assessment ("ICA"), which is the company's own assessment of its capital requirements. Pillar II is intended to provide a more realistic and complete view of the risks to which the company is exposed and to provide a framework within which the company should be managed.
- 2.21. The FSA requires firms, when preparing their ICA, to identify the major risks they face and, where capital is appropriate to mitigate those risks, to quantify how much (and what type) of capital is appropriate. The FSA expects firms to conduct stress tests and scenario analyses in respect of each risk. The capital requirements so determined are then aggregated allowing for diversification between risks where appropriate. These stress tests and scenario analyses, together with the supporting analysis, should be documented and, along with the results,

submitted to the FSA (on request) as the ICA. The company is not required to publish its Pillar II capital requirement.

- 2.22. The FSA will review the ICA periodically and may prescribe an additional amount of capital that must be held by the firm in addition to the ICA. The total amount of Pillar II capital prescribed by the FSA is usually expressed as a percentage of the ICA capital, and is called Individual Capital Guidance (“ICG”).
- 2.23. For the ICA, a firm will assess the amount of capital it needs to hold to remain able to meet its liabilities as they fall due in all but the most extreme circumstances. The FSA has indicated that ICG will be given taking into consideration capital resources consistent with a 99.5% confidence level that the firm will be able to meet its liabilities over a one year timeframe or, if appropriate to the firm’s business, an equivalent lower confidence level over a longer timeframe.

Solvency II

- 2.24. The regulatory solvency reporting requirements for EU insurers and reinsurers are due to undergo a major overhaul. The start date for the implementation of this new regime was set as the start of 2013 but recent communications from the European Commission (“EC”) appear to suggest that this will be changed. This new regime is called Solvency II and aims to introduce solvency requirements that better reflect the risks that insurers and reinsurers actually face and to introduce consistency across the European Union. UK companies will be required to adhere to a set of new, risk based capital requirements and, in contrast to the position under the current UK Pillar II requirements, the results will be shared with the public.
- 2.25. Solvency II will be a principles-based regime and will be based on three pillars:
- Under Pillar I quantitative requirements define a market consistent¹ framework for valuing the company’s assets and liabilities
 - Under Pillar II, insurers must meet minimum standards for their corporate governance, and also for their risk and capital management. There is a requirement for permanent internal audit and actuarial functions. Insurers must regularly complete an Own Risk and Solvency Assessment (“ORSA”).
 - Under Pillar III, there are explicit requirements governing disclosures to supervisors and policyholders.
- 2.26. The Solvency Capital Requirement (“SCR”) in Solvency II is the amount of capital required to ensure continued solvency over a 1 year time frame with a probability of 99.5%. The SCR is calculated based on the particular risks to which the insurer is exposed.
- 2.27. The Minimum Capital Requirement (“MCR”), which will be lower than the SCR, defines the point of intensive regulatory intervention. The MCR calculation is more formulaic and less risk sensitive than the SCR calculation.
- 2.28. In order to allow companies, supervisors and the EC to consider the likely effects of the new regime on insurers and reinsurers, the industry has undertaken a number of trial runs, called “Quantitative Impact Studies” (“QIS”) and produced results under the Solvency II rules as they have developed. The most recent of these, QIS 5, was completed in November 2010. Following the collection and preliminary analysis of the QIS 5 results the EC set up a task force consisting of selected national regulators, finance ministries, and industry representatives, to consider various issues relating to Solvency II. As a result of work carried out by this task force, various announcements have been made by the EC regarding possible new approaches. The principles and rules set out in the technical specification for QIS 5, updated to reflect the various EC announcements are, at the time of writing this report, the most up to date indication of the final form of Solvency II.

The financial information in this report

- 2.29. The Pillar I balance sheets as at 31 December 2010 are shown in Appendix 1.

¹ A market-consistent framework requires the values placed on assets and liabilities to be consistent with the market prices of listed securities and traded derivative instruments.

- 2.30. The RLL balance sheet is based on the published accounts that have been externally audited and signed off by the Board.
- 2.31. The PUKL balance sheet is based on the published accounts that have been externally audited and signed off by the Board. This balance sheet has been amended to reflect significant changes to the PUKL financial position that occurred after 31 December 2010.
- 2.32. I have seen Pillar II financials for both RLL and PUKL as at 31 December 2010 and discussed them with the senior management and Actuarial Function Holders (“AFHs”) of RLL and PUKL. Pillar II financial information is not published and remains private between the FSA and the company and I have therefore not included any Pillar II figures in this report.

3. BACKGROUND ON COMPANIES CONCERNED IN THE SCHEME

RLL

Background

- 3.1. Rothesay Life Limited ("RLL") is a proprietary company established in 2007. The shares of RLL are wholly-owned by Rothesay Life (Cayman) Limited and the ultimate parent company is The Goldman Sachs Group, Inc.
- 3.2. Previously, RLL was known as Hackremco Limited (until 14 March 2007) and First Premium Company Limited (until 16 May 2007).
- 3.3. RLL is authorised and regulated by the FSA, with permission to write business falling in Classes I, III, IV and VII.
- 3.4. The RLL operational structure is summarised in Chart 2 in Appendix 4.

Current fund structure

- 3.5. In accordance with UK regulations regarding UK shareholder owned life insurance companies, RLL currently has a shareholders' fund ("RLL SHF") and a long-term insurance fund (the "RLL LTF").
- 3.6. RLL writes long-term insurance business in the UK pension and annuity sector, by issuing:
 - Bulk purchase annuity contracts to trustees of UK defined benefit pension schemes by way of either a buy-in policy or a buy-out policy;
 - Individual policies to pension scheme beneficiaries in consequence of a buy-out of their benefits by the insurance company; and
 - Longevity swaps.
- 3.7. Buy-outs or buy-ins are insurance arrangements between pension scheme trustees of a defined benefit scheme and an insurer, under which trustees will nominally receive an annuity in respect of the benefits payable under the scheme in exchange for the payment of a premium to the insurer. Under buy-outs and buy-ins, the insurance risk (i.e. predominantly longevity risk) and market risk associated with the assets are transferred to the insurer.
- 3.8. Under longevity swaps, the pension scheme trustees pay out a fixed stream of payments, and, in return receive an uncertain stream of payments based on the benefits payable under a portfolio of pension benefits. The fixed payment stream is agreed at outset and the amount remains unchanged during the term of the longevity swap contract. The receivable payment stream reflects the benefits payable under the scheme. Longevity swaps are a transfer of longevity risk to the insurer, although some market risk may also be transferred under the contract.
- 3.9. Under a buy-out, the insurer will issue individual policies to pension scheme beneficiaries, thereby discharging the trustees from the scheme obligations. Under buy-ins and longevity swaps, the trustees retain their statutory obligation to the scheme (e.g. in the event of a payment default by the insurer).
- 3.10. As at the end of 2010, RLL has completed transactions with six pension schemes. Three of these transactions are 'unfunded', such that the trustees are required to pay regular premiums to secure future benefits (longevity swaps are included in this category). The remaining transactions have been on a 'funded' basis, such that RLL also takes on the investment risks associated with the assets of the scheme, for example through a single premium paid by the trustees.
- 3.11. RLL has exclusively written pensions business in the UK, which consists predominantly of non-linked and index-linked immediate and deferred annuities. Since inception, RLL has insured over £4 billion of pension liabilities. As at the end of 2010, RLL long-term insurance business consisted of approximately 47,000 policyholders and scheme members, comprising:
 - In-payment and deferred fixed annuities (group and individual); and
 - In-payment and deferred index-linked annuities (group and individual).

3.12. Table 1 in Appendix 1 shows the financial position of RLL as at 31 December 2010.

Reinsurance arrangements

- 3.13. RLL currently has eight quota share longevity swap arrangements in place, three with each of Pacific Life Re Limited and Royal Bank of Canada Insurance Company Limited and one with each of RGA Reinsurance UK Limited and Prudential Retirement Insurance and Annuity Company. These swaps provide mortality cover in respect of the business reinsured. The reinsurance arrangements cover approximately 80% of future annuity payments on all of the longevity swaps.
- 3.14. The total liabilities in respect of reinsurance ceded are approximately 20% of the total RLL gross mathematical reserves as at the end of 2010.

Options and Guarantees

- 3.15. Individual deferred annuities may be transferred to another pension scheme and the transfer value will be calculated on non-guaranteed terms intended to be broadly profit-neutral to RLL. That is to say, the transfer value is calculated using assumptions that reflect market conditions at the time of transfer such that RLL is indifferent as to whether the annuitant transfers or not. Therefore, if market conditions have generally led to an increase in the value of RLL's best estimate of its liabilities, the transfer value will increase and vice versa. Where these transfer values are guaranteed for a period of time and the transfer is offered to the annuitant as an option during this period, an adjustment will be made to reflect the option value implicit in the offer.
- 3.16. Trustees also have the option to surrender a bulk annuity policy for a surrender payment that is calculated broadly on a basis that is profit-neutral to RLL. This option may only be exercised in the event of a 'default' by RLL, typically when solvency cover falls below a pre-defined trigger level which is close to the statutory insolvency level. If solvency cover is above this trigger point, the option cannot be exercised.

Administration

- 3.17. All administration arrangements for RLL bulk and individual policies are currently provided by Towers Watson.

Investment strategy

- 3.18. UK insurers typically back annuity business with fixed interest assets (such as government bonds or corporate bonds) and generally hold these assets to maturity. These assets are typically unsecured and therefore expose the insurers to the risk that a bond issuer defaults on the payments due under the bond (credit risk).
- 3.19. The yield earned on a corporate bond is typically greater than that earned on a similar (in terms of duration, coupon rate etc.) government bond. This excess yield above the yield available on a similar government security is called the credit spread. The credit spread can be broken into the following components:
- Compensation for expected losses on default of the bond issuer (A).
 - Compensation for unexpected default losses, or the uncertainty surrounding the timing and extent of defaults (B).
 - Compensation for the illiquidity of corporate bonds and the risk of not finding a buyer at the prevailing market price (C).
 - Compensation for other 'non-credit' factors such as investor behaviour (D).
- 3.20. The sum of A and B is known as the 'credit risk premium'. The uplift in yield resulting from C is the 'illiquidity premium'. The effects of D are often disregarded or not differentiated from C.
- 3.21. RLL has entered into credit derivatives and other collateralised swap arrangements in order to hedge out a significant proportion of the credit risk associated with such investments and therefore better match its liabilities.

3.22. Such an asset strategy mitigates exposure to the risks associated with the defaults of bond issuers and the widening of credit spreads and it essentially locks in the illiquidity premium. However, in common with other annuity providers, RLL is still exposed to reinvestment risk. This arises where the assets held are of shorter duration than the liabilities and therefore proceeds of the maturing assets need to be reinvested at certain points in the future at uncertain future yields. RLL is therefore exposed to the risk that the illiquidity premium available at the point of reinvestment is lower than anticipated (illiquidity premium risk).

The risk profile of RLL

3.23. As an annuity company, the key risks to which RLL is exposed in the management of its annuity business are insurance risk and market risk.

3.24. Insurance risk for RLL is mainly longevity risk; this is the risk that the annuitant will live longer than expected and that the insurance company will have to provide annuity payments to the policyholder for a longer period than anticipated.

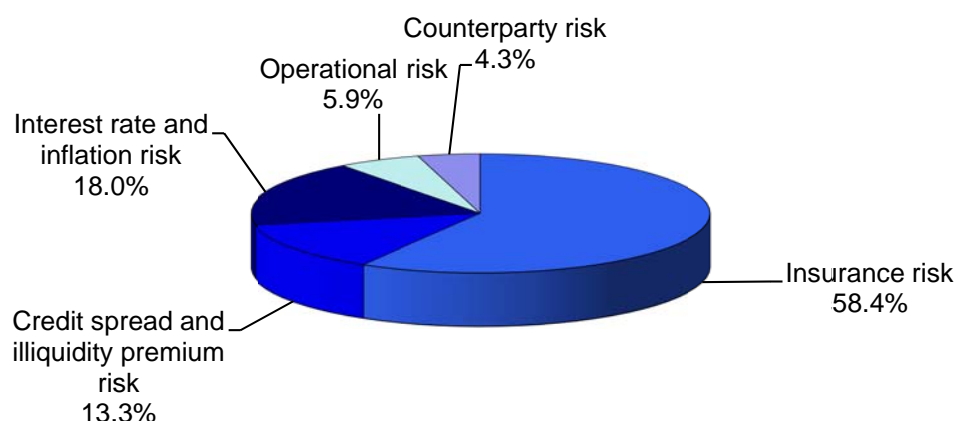
3.25. The market risks to which RLL is exposed can be broken down into the following main constituents:

- Spread risk is the risk that, following a movement credit spreads, the market value of the assets backing the liabilities falls by more than, or increases by less than, the value of the liabilities.
- Illiquidity premium risk (as described above) is the risk that changes in the illiquidity premium mean that maturing assets can only be reinvested to earn lower returns in the future.
- Counterparty risk is the risk that a counterparty of RLL (e.g. swap counterparties or reinsurers) fail to meet their financial obligations to RLL and that posted collateral is insufficient to fully compensate RLL.
- Interest rate risk is the risk that, following a change in the level or volatility of interest rates, the market value of the assets backing the liabilities falls by more than, or increases by less than, the value of the liabilities.
- Inflation risk in this context is the risk that the level of payments due to annuitants with inflation-linked policies increases by more than the income received from the assets held to back these policies.

3.26. However, though the use of collateralised arrangements, RLL has significantly reduced the spread risk associated with its asset portfolio and mitigated its counterparty risk. These arrangements also have the effect of hedging out the majority of RLL's interest rate and inflation risk.

3.27. As a result, the largest Pillar II capital requirement is that due to longevity risk.

3.28. A summary of the RLL risk profile at the 99.5th percentile, before diversification benefits, is provided below:



Source: Rothesay Life ICA 31 August 2010

- 3.29. As at 31 December 2010, under the current regulatory regime, Pillar I is the more onerous capital requirement for RLL.

PUKL

Background

- 3.30. Paternoster UK Limited ("PUKL") was established in 2005 and is a proprietary company focussing on bulk annuity transaction in the UK. PUKL, along with the rest of the Paternoster Group, was purchased by Rothesay Life (Cayman) Limited on 11 January 2011. The ultimate parent company is Goldman Sachs Group, Inc.
- 3.31. After the purchase, Rothesay Life (Cayman) Limited injected £60m of additional equity and £100m of subordinated debt into PUKL.
- 3.32. PUKL is authorised and regulated by the FSA since 2006, with permission to carry on business falling in Classes I, III, IV and VII. PUKL stopped writing new bulk annuity business in 2008, and in 2009 the FSA changed its new business permission such that PUKL would not effect new contracts of insurance.
- 3.33. A summary of PUKL organisational structure in the Goldman Sachs Group, Inc. is summarised in Chart 1 in Appendix 4:
- Paternoster Services Limited ("Paternoster Services"), currently provides UK-based services for PUKL, including business development, operations activities, and management personnel for pricing, investment, mortality and financial divisions. It is also authorised by FSA to provide intermediary insurance activities.
 - Paternoster India Private Limited (PIPL) currently provides PUKL with technical pricing, investment, finance and mortality analytical services. The intention is for these services to be provided via UK-based arrangements, and PIPL is therefore in the process of being wound down.
 - Paternoster Financial Services provided intra-group financing and acts as an intermediary between PUKL and Paternoster Limited in respect of the contingent loan facility entered into in August 2008.

Current fund structure

- 3.34. In accordance with UK regulations regarding UK shareholder owned life insurance companies, PUKL currently has a shareholders' fund (the "PUKL SHF") and a long-term insurance fund (the "PUKL LTF").
- 3.35. PUKL has written long-term insurance business, accounting for approximately £2.9 billion of mathematical reserves (net of reinsurance) as at the end of 2010:
- Bulk purchase annuity contracts to trustees of UK defined benefit pension schemes by way of either a buy-in policy or a buy-out policy; and
 - Individual policies to pension scheme beneficiaries resulting from a buy out of their benefits by the insurance company.
- 3.36. As at the end of 2010, PUKL had completed a total of 42 transactions with pension schemes since 2006. All the business written by PUKL is conventional deferred and immediate bulk annuities, funded by an upfront single premium payable by the trustees during the transaction.
- 3.37. The in-force bulk purchase annuity contracts issued by PUKL cover approximately 20 pension schemes. In addition, there are individual policyholders as a result of the conversion of bulk policies to individual policies when schemes are wound up.
- 3.38. All of PUKL's business is non-profit annuity business written in the UK as pensions business. As at the end of 2010, PUKL's long-term insurance business consisted of approximately 44,000 policyholders and scheme members, comprising:

- In-payment and deferred fixed annuities (group and individual) (approximately 10,000 policyholders and scheme members); and
 - In-payment index-linked annuities (group and individual) (approximately 34,000 policyholders and scheme members).
- 3.39. Following the acquisition by Rothesay Life (Cayman) Limited, the financial position of PUKL changed fundamentally after 31 December 2010 due to the following:
- A capital injection of £60m equity and £100m subordinated debt;
 - The purchase of a total return swap (further described in paragraph 3.49);
 - A release of expense reserves reflecting the efficiencies of a shared cost base;
 - The alignment of longevity assumptions with those of RLL.
- 3.40. As a consequence of these changes, the financial strength of PUKL improved significantly as it benefited from a capital injection and from the economies of scale from becoming part of a larger group. The purchase of the total return swap also removed a significant proportion of the credit risk associated with PUKL's bond portfolio.
- 3.41. Table 2 in Appendix 1 shows the financial position of PUKL at 31 December 2010 amended to reflect the above. Appendix 3 contains a reconciliation of the PUKL financial position as published in the FSA Returns as at 31 December 2010 with the amended position.

Reinsurance arrangements

- 3.42. PUKL currently has one reinsurance arrangement in place with an external reinsurer, Hannover Re. This reinsurance arrangement is a longevity reinsurance contract covering pensioners in 28 schemes in which regular premiums, derived using a fixed set of mortality assumptions, are paid for by the insurer. The reinsurer pays claims reflecting the survival of the pensioners covered by the treaty.
- 3.43. The total liabilities in respect of reinsurance ceded are less than 1% of the total PUKL gross mathematical reserves as at the end of 2010.

Options and Guarantees

- 3.44. One buy-in policy provides the trustee policyholder with an option to surrender the policy in the event that the Pillar 1 free assets fall below an agreed threshold. Under the terms of the surrender the policyholder is entitled to receive a surrender payment substantially the same as the liability held on PUKL's balance sheet. In the event that the threshold is breached and the option to surrender is exercised, the overall Pillar 1 solvency position (excess capital) of PUKL would improve.
- 3.45. There are two further buy-in policies whereby PUKL has offered to underwrite annuities for a defined group of future retirees on pre-set longevity and expense assumptions. For the larger of the two policies, this commitment lapses in February 2012. The aggregate premium for both policies is unlikely to amount to more than £15m.
- 3.46. In addition, individual deferred annuities may be transferred to another pension scheme and the transfer value will be calculated on a contractually defined basis which is broadly profit neutral to PUKL. That is to say, the transfer value is calculated using assumptions that reflect market conditions at the time of transfer such that PUKL is indifferent to whether the annuitant transfers or not. Therefore, if market conditions have generally led to an increase in the value of PUKL's best estimate of its liabilities, the transfer value will increase and vice versa. Where these transfer values are guaranteed for a period of time and the transfer is offered to the annuitant as an option during this period, an adjustment will be made to reflect the option value implicit in the offer.

Administration

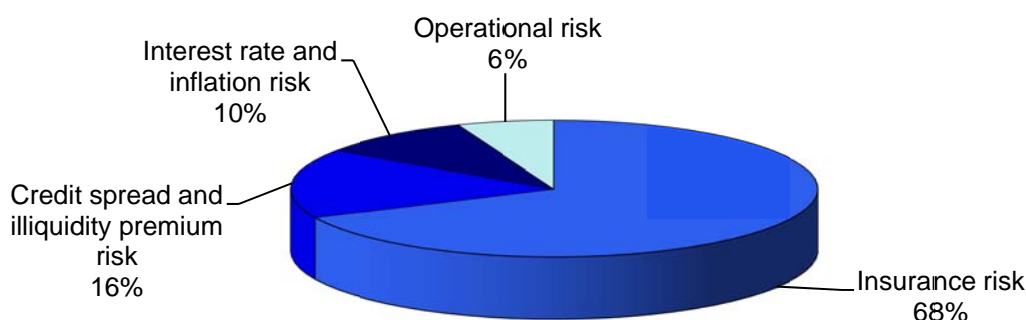
- 3.47. PUKL policies are currently administered by JLT, who are the third party administration provider for PUKL.

Investment Strategy

- 3.48. Prior to the sale to Rothesay Life (Cayman) Limited, PUKL's asset strategy was to invest in long-dated corporate credit (with appropriate interest rate and inflation swaps).
- 3.49. Following the acquisition by Rothesay Life (Cayman) Limited, PUKL entered into a collateralised total return swap. This is a full term total return swap which matches liabilities that are broadly consistent with the Pillar 1 liabilities. This asset strategy is similar to that being utilised by RLL.

The risk profile of PUKL

- 3.50. The risk profile of PUKL is similar to that of RLL and the key risks for PUKL are longevity risk and market risk.
- 3.51. PUKL has also entered into a collateralised total return swap arrangement, which, as with RLL, has reduced its exposure to credit risk. PUKL does not have as much reinsurance in place as RLL.
- 3.52. Therefore, the largest Pillar II capital amount required is attributed to longevity risk.
- 3.53. As at 31 December 2010, Pillar I is the more onerous capital requirement for PUKL.
- 3.54. A summary of the PUKL risk profile at the 99.5th percentile, before diversification benefits, is provided below:



Source: PUKL ICA as at 31 December 2010

4. THE PROPOSED SCHEME

Motivation for the Scheme

- 4.1. The proposed Scheme will simplify the UK corporate structure, reduce administrative and overhead management costs and increase opportunity to diversify risk by combining businesses within a single entity, thereby achieving capital efficiency. Implementation of the Scheme will also facilitate the response to regulatory developments such as Solvency II and lead to simpler and clearer customer communication.

Summary of the Scheme

- 4.2. The Scheme is scheduled to be presented to the High Court in the fourth quarter of 2011. If it is approved by the High Court, then on 14 December 2011 (the "Effective Date"), the long-term insurance business of PUKL, together with the assets attributed to the PUKL long-term insurance business will transfer to the RLL LTF. Assets in the PUKL SHF will transfer to the RLL SHF with the exception of assets to cover PUKL's minimum statutory capital requirements (the BCRR) which will remain in the PUKL SHF until PUKL is de-authorised and liquidated whereupon these assets will be transferred to the RLL SHF.
- 4.3. Although not within the scope of the Scheme, I have assumed, in this report, that the PUKL SHF assets retained to cover the BCRR are transferred across to the RLL SHF as I am satisfied that it is management's intention to de-authorise and liquidate PUKL soon after the implementation of the Scheme.

Transferring assets and liabilities

- 4.4. Under the proposed Scheme, all of the long-term insurance business of PUKL will be transferred to the RLL LTF.
- 4.5. All of the assets attributed to the long-term insurance business of PUKL will be transferred to the RLL LTF.
- 4.6. All of the liabilities of the PUKL SHF will be transferred to the RLL SHF.
- 4.7. With the exception of assets retained in PUKL to cover its BCRR, the assets in the PUKL SHF will be transferred to RLL.

Reinsurance arrangements

- 4.8. The external reinsurance arrangements referred to in Section 3 will continue, with RLL being the cedant in place of PUKL.

Administration

- 4.9. After the Scheme, the obligations to administer the transferred policies under the administration agreement will transfer to RLL. All existing administration arrangements will remain in place and continue to operate as before. The transferring PUKL policies will continue to be administered by JLT and Paternoster Services, where relevant, and RLL policies will continue to be administered by Towers Watson.

Cost of the Scheme

- 4.10. The cost of the Scheme will be borne by the RLL SHF.

Tax

- 4.11. PUKL is currently taxed as a proprietary life assurance company. I have been informed by the management of PUKL that there is no expectation of any changes to the tax position of the transferring PUKL policies, and the existing RLL policies in the RLL LTF as a result of the Scheme and that they will continue to be subject to the same tax regime.

- 4.12. I have been assured that the taxation of RLL is expected to be materially unaffected by the Scheme and that there will be no impact on the tax charged to policies.
- 4.13. All appropriate tax clearances will be applied for from the relevant authorities and I have been informed by the management of RLL that these are expected to be granted. The transfer is conditional on these clearances being obtained.

Excluded policies

- 4.14. An “Excluded Policy” is defined as a PUKL policy which:
- Was written in an EEA state outside the UK and for which the FSA has not provided the certificate referred to in paragraph 4 of Part 1 of Schedule 12 to FSMA with respect to the relevant EEA state;
 - Is not otherwise capable of being transferred pursuant to FSMA on the Effective Date or which the Court determines not to transfer by virtue of the Order;
- 4.15. Any policy that is an Excluded Policy, and as a result cannot be transferred as part of the proposed Scheme on the Effective Date will be reinsured into RLL through an Excluded Policies reinsurance arrangement from the Effective Date on a basis intended to replicate the financial effects of a transfer of such policies to RLL.
- 4.16. There are not expected to be any Excluded Policies.

Residual Assets

- 4.17. “Residual Assets” are those assets that are not able to be transferred on the effective date of the transfer.
- 4.18. There are not expected to be any Residual Assets.

Structure after the Scheme

- 4.19. After the Scheme, PUKL will have no long-term insurance business in the PUKL LTF, with the exception of any Excluded Policies. All of the PUKL long-term insurance business, with the exception of any Excluded Policies will be within the RLL LTF.
- 4.20. After the Scheme, PUKL will have no assets in the PUKL LTF, with the exception of any Residual Assets. All PUKL assets previously in the PUKL LTF with the exception of any Residual Assets will be within the RLL LTF.
- 4.21. After the Scheme, all PUKL SHF assets (with the exception of those required to cover PUKL’s BCRR) will be within the RLL SHF.
- 4.22. After the Scheme, all PUKL SHF liabilities will be within the RLL SHF.

5. THE EFFECT OF THE SCHEME ON THE PUKL POLICYHOLDERS

Introduction

- 5.1. In this section I consider the effect of the Scheme on the existing policyholders of PUKL.
- 5.2. Under the Scheme these policies will be transferred to RLL. As long-term insurance contracts they will be transferred into the RLL LTF. Therefore, the key considerations with respect to the effect of the Scheme on the current PUKL long-term insurance policyholders are:
- The change in the financial strength available to provide support for the security of policyholders' benefits as a result of the implementation of the Scheme;
 - The profile of risks to which the PUKL policies will be exposed after the implementation of the Scheme; and
 - The effect of the Scheme on the benefit expectations of the transferring policyholders, including the service levels, management, governance and administration standards the PUKL policyholders should expect after the transfer.
- 5.3. I cover each of these points in the sections below.

The financial strength available to provide security of benefits

The financial strength available pre and post transfer

- 5.4. As described in Section 3 of this report, on 11 January 2011 RLL purchased PUKL. As a result of this transaction, PUKL made some material changes to its balance sheet. As described in Section 3, these changes are:
- A capital injection of £60m equity and £100m subordinated debt;
 - The purchase of a total return swap (as described in paragraph 3.49);
 - A release of expense reserves reflecting the efficiencies of a shared cost base; and
 - The alignment of longevity assumptions with those of RLL.
- 5.5. The 2010 published year end financials are therefore of limited use in considering the current position of PUKL and its policyholders. Therefore PUKL have drawn up financials as at 31 December 2010 which reflect the changes that occurred as a result of the transaction on 11 January 2011. A reconciliation of the actual published, Board approved and externally audited 2010 year end position to this new 'post transaction' end of 2010 financial position is shown in Appendix 3.
- 5.6. In my opinion this adjusted 2010 year end position is the appropriate starting point from which to analyse the effects of the Scheme and the 'pre-Scheme' position for the PUKL policyholders. I have carried out a high level review of the adjusted 2010 year end position and the reconciliation back to the published, audited 2010 year end position and I am satisfied that it is appropriate for me to rely on this in forming my conclusions about the Scheme.
- 5.7. The tables in Appendices 1 and 2 show the relative financial strength of PUKL currently and RLL after the implementation of the Scheme. These tables show that, as a result of the Scheme, based on the adjusted financials as at 31 December 2010:
- The excess assets as a percentage of total liabilities are 11% currently in PUKL and are projected to be 12% in RLL after the transfer; and
 - The excess assets currently cover the PUKL CRR by 2.6 times and RLL after the transfer is projected to have excess assets that will cover the combined RLL CRR by 2.8 times.

- 5.8. The excess assets of 12% of total liabilities and CRR coverage of 2.8 times are higher than the financial strength currently available in PUKL. In addition, the absolute amount of capital available in RLL to provide support is also larger than that in PUKL currently.
- 5.9. I have discussed the Pillar II financial position for PUKL with the senior management at PUKL. As with the Pillar I position (described above), the material changes as a result of the transaction on 11 January 2011 mean that the Pillar II financials submitted to, and reviewed by, the FSA, require adjustment. I have undertaken a high level review of the adjustments and I am comfortable with the PUKL AFH's conclusion that for PUKL it is the Pillar I capital requirements that are the more onerous.
- 5.10. After the transfer, the combined company is projected to comfortably meet its Pillar II capital requirements with a material increase in the excess assets available after coverage of the ICA. For the post transfer merged entity it appears clear that the Pillar I capital constraints will be the more onerous.
- 5.11. Therefore, on both a Pillar I and a Pillar II basis, RLL (including the transferred PUKL long-term insurance business) is projected to be financially strong.

Current initiatives by PUKL

- 5.12. PUKL senior management have made me aware of the following current initiatives that could change the ratios and coverage numbers in the post transfer RLL. These are:
- PUKL is currently considering entering into a longevity risk transfer contract. This is a contract whereby PUKL would agree to pay fixed amounts to a reinsurer over time in return for receiving a variable payment from a reinsurer reflecting changes to the longevity of the insured portfolio. Under such a contract, PUKL would be protected to some extent from increases in life expectancy but would not benefit from any increase in mortality. By entering into any contract such as this, there is necessarily a small increase to the credit exposure to counterparties and to the operational risks within the business.
 - PUKL is considering changing the counterparty of some proportion of the total return swap. Such a change would broaden the range of counterparties to which PUKL is exposed and, depending on the terms which are agreed, could change the returns which PUKL receives over time. This could change the valuation interest rate and could introduce some reinvestment risk.
- 5.13. These are included here for completeness only, I am satisfied that these are not likely to have a material adverse effect on the financial strength available to support the security of policyholders' benefits in the of the post transfer RLL.

The capital policy for the future

- 5.14. In addition to the security provided by the financial strength of the merged business immediately after the transfer, it is important to consider the security provided to the transferring policyholders in the longer term if the Scheme is implemented. I have had a series of detailed discussions with the senior management of RLL with respect to their management of RLL (including the current PUKL long-term insurance business) in the future and in particular with respect to the excess capital they intend to hold in the merged company after the implementation of the Scheme.
- 5.15. The Board have recently approved a capital policy for the post-transfer RLL and, in summary, this includes a commitment by the Board to:
- Retain sufficient capital (Pillar I admissible assets less Pillar I total liabilities) as shown in the externally audited FSA Returns of at least 150% of the Pillar I CRR;
 - Retain sufficient capital such that RLL will remain solvent over a one year time horizon with a probability of at least 99.8%; and
 - Construct a capital policy that offers policyholders an equivalent level of protection under Solvency II when this new reporting standard is introduced.

- 5.16. The capital policy will be reviewed regularly by the RLL Board to ensure that it remains appropriate and there are various safeguards in place concerning future changes to this policy and the transition of the capital policy to Solvency II. Any future changes to the capital policy will be approved by the Board after appropriate consultation with the FSA.
- 5.17. At 150% of CRR, the minimum level of capital required by the capital policy is significantly lower than the projected level of capital in RLL immediately after the transfer on a Pillar I basis (283%) as shown in Appendix 2. I have discussed with senior management their intentions with respect to capital management in RLL after the Scheme is implemented.
- 5.18. At the time of the purchase of PUKL by Rothesay Life (Cayman) Limited, £100 million of subordinated debt was injected into PUKL (as described in Section 3). This injection was to expedite the change of control for the PUKL business and was not considered a permanent injection and it is the RLL Board's intention that this should be reversed when it is appropriate to do so.
- 5.19. With the exception of the possibility of repaying the subordinated debt of £100 million (plus accrued interest), the RLL Board has no intention to extract excess capital from RLL.
- 5.20. It should be noted that the excess capital ratio of RLL could decrease over time through the writing of new long-term insurance business but this could happen currently, subject to various logistical hurdles, and is not a result of the Scheme.

Conclusion on the financial strength available to provide support

- 5.21. Based on the projected level of capital in RLL after the transfer, and the capital policy set for the future, although the financial strength providing support will change, I am satisfied that the security of the benefits under the PUKL long-term insurance policies will not be materially adversely affected as a result of this change.

The profile of risks to which the PUKL policies are exposed

- 5.22. PUKL and RLL write similar types of business and are therefore exposed to similar types of risk. However, there are some differences:
- The underlying policyholder groups in each of the companies are different - for example their demographics, their occupations, their geographical area etc.
 - The operational risks in each company will be different.
 - The assets actually held will present different risks.
 - The Schemes in each company have different options and guarantees attached to them.
- 5.23. Therefore, although similar before and after the transfer, the transfer will change the profile of risks to which the PUKL policies are exposed.
- 5.24. Both the Pillar I and Pillar II financials, to differing degrees, allow for the risk exposures of each company and, as discussed above, after the transfer RLL is projected to cover its Pillar I and Pillar II capital requirements comfortably. Therefore, although the implementation of the Scheme will lead to a change to the risk profile to which the PUKL policyholders are exposed, this will be mitigated by the overall financial strength of RLL after the Scheme. Therefore, I am satisfied that this change will not have a material adverse effect on the security of the benefits under the PUKL policies.

The benefit expectations of the PUKL policyholders

- 5.25. After the Scheme, all of the existing customer administration arrangements will remain in place. JLT will continue to provide administration services and customer support in relation to the existing PUKL policies and Towers Watson will continue to provide the same in respect of the existing RLL policies.

- 5.26. Therefore, the Scheme will not lead to any change in the administration and service standards received by the current PUKL policyholders.
- 5.27. There will be no change to the policies' terms and conditions, although there may be some minor changes to certain outputs and documentation as a result of the transfer, such as documentation and communications re-branded to RLL.
- 5.28. After the transfer, the RLL Board will be responsible for the governance of the transferring PUKL policies. The RLL Board currently carries out this governance role for similar non-profit business and so is aware of the issues affecting the transferring non-profit business. There are several members of the current PUKL Board who will be members of the RLL Board after the transfer.
- 5.29. Therefore, the Scheme will not have a material effect on the governance received by the current PUKL long-term insurance business.
- 5.30. Therefore, I am satisfied that the Scheme will not have a material adverse effect on the benefit expectations of the long-term insurance policyholders of PUKL.

Conclusion for the current PUKL long-term insurance policyholders

- 5.31. I am satisfied that the Scheme will not have a material adverse effect on:
- The security of benefits of the long-term insurance policyholders of PUKL;
 - The benefit expectations of the long-term insurance policyholders of PUKL; or
 - The service standards and governance received by the long-term insurance policies of PUKL.

6. THE EFFECT OF THE SCHEME ON THE RLL POLICYHOLDERS

Introduction

- 6.1. In this section I consider the effect of the Scheme on the existing policyholders of RLL.
- 6.2. Under the Scheme, these policies will remain in RLL. The key considerations in respect of the Scheme for these policyholders are the effects of the transfer into RLL of the PUKL policyholders on:
- The financial strength available to provide support for the security of the RLL policyholders' benefits;
 - The profile of risks to which the RLL policyholders will be exposed after the implementation of the Scheme; and
 - The benefit expectations of the long-term insurance policyholders of RLL.
- 6.3. I cover each of these points in the sections below.

The financial strength available to provide security of benefits

- 6.4. After the Scheme, support for the security of the guaranteed benefits of the existing policyholders of RLL will continue to be provided by the strength of the reserves in the RLL LTF, the excess assets in the RLL LTF, and the capital support available from outside of the RLL LTF – i.e. from the RLL SHF and the wider group.
- 6.5. Implementation of the Scheme will have no effect on the strength of the reserving basis for the RLL long-term insurance business.
- 6.6. The block of business being transferred into RLL LTF under the Scheme, has total liabilities (including mathematical reserves) of £2.995 billion (as at 31 December 2010). This is considerably more than the total liabilities of RLL of £1.027 billion.
- 6.7. As shown in Appendices 1 and 2, implementation of the Scheme is projected to reduce both the ratio of excess assets as a percentage of total liabilities on a Pillar I basis and the coverage for the CRR in RLL. The excess assets as a percentage of the total liabilities are projected to decrease from 16% to 12% and the coverage for the CRR is projected to decrease from 3.5 times to 2.8 times.
- 6.8. However, counteracting these, I note that, after the transfer:
- The absolute amount of Pillar I excess capital, before the CRR, increases (from £162 million to £488 million); and
 - The coverage for the Pillar I CRR remains high, and excess assets coverage of the CRR by 2.8 times is an indication of significant financial strength.
- 6.9. The level of excess capital in RLL, on a Pillar I basis as at the end of 2010, is currently high and has been maintained at a high level in preparation for the transfer in of PUKL. I understand from RLL senior management that, if the proposed transfer does not proceed, there is no intention to necessarily maintain this high level of excess capital.
- 6.10. I have discussed the Pillar II financial position for RLL and PUKL with the senior management at RLL and PUKL and similar conclusions can be made when considering the Pillar II financials as on a Pillar I basis. For both RLL and PUKL, the Pillar I capital requirements are more onerous than the Pillar II capital requirements currently and the same is projected to be true for the merged entity after the implementation of the Scheme. Based on the projected Pillar II financials for RLL after the implementation of the Scheme, the combined company is projected to comfortably meet its Pillar II capital requirements with a significant increase in the excess assets available after coverage of the ICA.

- 6.11. Therefore, on both a Pillar I and a Pillar II basis, RLL (including the transferred PUKL long-term insurance business) is projected to be financially strong after the Scheme.

The capital policy for the future

- 6.12. In addition to the security provided by the financial strength of the merged business immediately after the transfer, it is important to consider the security provided in the longer term if the Scheme is implemented. I have had a series of detailed discussions with the senior management of RLL with respect to their management of RLL (including the current PUKL long-term insurance business) in the future and in particular with respect to the excess capital they intend to hold in the merged company after the implementation of the Scheme.
- 6.13. The Board has recently approved a capital policy for the post transfer RLL. I cover the relevant considerations for the future capital management of RLL in Section 5 and I do not repeat them here.
- 6.14. In conclusion, based on the projected level of capital in RLL after the transfer, and the capital policy set for RLL in the future, although the financial strength providing support will change, I am satisfied that the security of the benefits under the current RLL long-term insurance policies will not be materially adversely affected as a result of this change.

The profile of risks to which the RLL policies are exposed

- 6.15. The transfer in of the PUKL business will introduce new risks and types of risk to the RLL LTF due to the different characteristics of the PUKL business. The PUKL business is, in general, similar to the existing RLL business but there are some key differences:
- PUKL has a larger number of smaller pension schemes (approximately 20 as at 31 December 2010) than RLL;
 - PUKL has a number of pension schemes with options and guarantees provided (as described in Section 3); and
 - The underlying policyholders and scheme members will have different demographic (age, sex, health etc.) characteristics to the existing RLL policyholders and scheme members.
- 6.16. Therefore, although similar before and after the transfer, there will be a change to the profile of risks to which the RLL policies are exposed as a result of the transfer.
- 6.17. Capital will be transferred into, and subsequently held in, the RLL LTF in respect of the risks associated with the transferring in PUKL long-term insurance business. The assets that will be transferred into the RLL LTF under the Scheme broadly match the expected term and pay-out profile of the transferring block of annuities, and the investment strategy of the PUKL assets is similar to that of RLL. This transferred in block of business is likely to be reasonably stable and is therefore unlikely to have excessive future demands for capital from the rest of the RLL LTF to cover its reserves and capital requirements.
- 6.18. Both the Pillar I and Pillar II financials, to differing degrees, allow for the risk exposures of each company and, as discussed above, after the transfer RLL is projected to cover its Pillar I and Pillar II capital requirements comfortably. Therefore, although the implementation of the Scheme will lead to a change to the risk profile to which the RLL policyholders are exposed, this will be mitigated by the overall financial strength of RLL after the Scheme. Therefore, I am satisfied that this change will not have a material adverse effect on the security of the benefits under the RLL policies.

The benefit expectations of the RLL policyholders

- 6.19. The Scheme will not lead to any change in:
- The administration and service standards received by the current RLL policyholders. The existing arrangements will remain in place and Towers Watson will continue to provide administration services and customer support in respect of the existing RLL policies.

- The RLL policies' terms and conditions
 - The governance applicable to the RLL policies – this will remain the responsibility of the RLL Board.
- 6.20. Assets are being transferred into the RLL LTF that more than cover the prudent reserves for the transferring in business and the capital requirements of that business on a Pillar I and Pillar II basis.
- 6.21. Therefore, I am satisfied that the Scheme will not have a material adverse effect on the benefit expectations of the long-term insurance policyholders of RLL.

Conclusion for the current RLL long-term insurance policyholders

- 6.22. I am satisfied that the Scheme will not have a material adverse effect on:
- The security of benefits of the long-term insurance policyholders of RLL;
 - The benefit expectations of the long-term insurance policyholders of RLL; or
 - The service standards and governance received by the long-term insurance policies of RLL.

7. OTHER CONSIDERATIONS DUE TO THE SCHEME

Solvency II

- 7.1. Significant parts of the regulations and principles under the Solvency II regime are only available in draft form at this time and in particular, there is considerable uncertainty around how annuity business will be valued under the new reporting standard. However, rather than the absolute position of each company under Solvency II, the key consideration should be the relative Solvency II position before and after the transfer. 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 financials of these companies in a similar way.
- 7.2. PUKL and RLL have provided Solvency II financials before and after the implementation of the Scheme on three different Solvency II bases. These three bases are:
- The QIS 5 basis. The industry wide QIS 5 exercise was carried out in 2010 based on the financial position as at the end of 2009. As described in Section 2, there were material changes to the PUKL balance sheet at the time of the acquisition of PUKL by RLL and therefore the actual QIS 5 numbers for PUKL are of limited use in the assessment of this transfer. The company has produced an estimated QIS 5 position, before and after the transfer for PUKL and RLL, as at 31 December 2010, assuming the changes due to the acquisition had occurred on this date.
 - A central basis. The QIS 5 basis modified to reflect announcements from the EC since the QIS 5 exercise was completed as this is considered to be the most current Solvency II basis for valuing annuity business.
 - An adverse alternative to the central basis.
- 7.3. On all of these Solvency II bases, analysis of the relative strengths of the companies, before and after the implementation of the Scheme, reveals a similar picture to that on the Pillar I and Pillar II bases under the current regime. Although the percentage coverage for the required capital is, in general, lower under Solvency II, the absolute excess capital levels are higher after the Scheme than before, and the diluting effect of the transfer on the financial strength is similar to that under Pillar I and Pillar II.
- 7.4. I am therefore satisfied that the issues that arise as a result of the transfer, are unlikely to be materially different when viewed from a Solvency II standpoint than they are when viewed from the standpoint of the current Pillar I and Pillar II regimes, and that therefore these issues are covered in Sections 5 and 6 of this report.

The approach to communication with policyholders

- 7.5. Regulations made under the FSMA require a communication regarding the proposed transfer to be sent to every policyholder of the parties under the Scheme. However, consideration may be given to the practicality and costs of sending notices against the likely benefits for policyholders of receiving such communications and I understand that PUKL and RLL propose to seek a dispensation from this requirement and to send communications regarding the Scheme to:
- The trustees of UK defined benefit pension schemes which have entered into bulk annuity contracts (buy-out or buy-in) with PUKL or RLL; and
 - The primary beneficiaries of individual policies issued by PUKL or RLL.
- 7.6. If the dispensation is granted then PUKL and RLL will not send communications regarding the Scheme to the underlying members of the pension schemes which have entered into bulk annuity contracts with PUKL or RLL. I understand that senior management at PUKL and RLL have spoken to the trustees of a number of bulk annuity buy-out or buy-in pension schemes who have all indicated that they agree with the proposed approach and that they would consider it inappropriate for PUKL or RLL to communicate directly with their members in respect of the Scheme. Their reasons for this include:

- The trustees of pension schemes have a fiduciary duty to their members and are responsible for running the pension scheme on behalf of the members.
- The pension scheme members may not be aware of the existence of the bulk annuity contract with PUKL or RLL, and/or that such a bulk annuity contract may only apply to a sub-group of the members, and so receiving a letter from PUKL and RLL may lead to confusion and concern.

7.7. It should also be noted that, in the majority of cases, PUKL and RLL do not have sufficient information to contact the underlying pension scheme members.

7.8. In order to comply with SUP 18.2.46G, the companies would be expected to notify the policyholders, or interested persons, at least six weeks before the date of the Court hearing at which the application to sanction the Scheme will be heard.

7.9. I am satisfied that it is appropriate and reasonable for PUKL and RLL to seek the dispensation and to communicate in respect of the Scheme as described above.

Service standards

7.10. The implementation of the Scheme will not lead to any change to the administration arrangements for the transferring policies of PUKL or to the administration arrangements for the existing RLL policies.

7.11. I am satisfied that the Scheme will not lead to a change in the service levels received by the transferring policyholders of PUKL or by the existing policyholders of RLL.

Costs of the Scheme

7.12. The costs of the Scheme will be paid by the RLL SHF.

Group structure

7.13. I am not aware of any proposed changes to the RLL group structure.

8. CONCLUSIONS

8.1. I am therefore satisfied 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.



Oliver Gillespie

Fellow of the Institute and Faculty of Actuaries

19 July 2011

APPENDIX 1 – SELECTED FINANCIAL INFORMATION AS AT 31 DECEMBER 2010

The figures in the tables below show the financial positions of RLL and PUKL respectively as at 31 December 2010. The figures shown are net of reinsurance. The RLL figures have been taken from the externally audited and Board approved 2010 year end FSA Returns. The 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 (see Appendix 3 for a reconciliation of the published and re-stated PUKL positions).

1. RLL

RLL		£m		
31 December 2010		RLL LTF	RLL SHF	RLL Total
Assets		1,135	55	1,190
Liabilities (net of reinsurance)	Conventional non-profit	76	0	76
	Index linked	634	0	634
	Sub total	710	0	710
	Other	317	0	317
	Total liabilities	1,027	0	1,027
Excess Assets		107	55	162
CRR				46
Excess Assets after CRR				116

2. PUKL

PUKL		£m		
31 December 2010		PUKL LTF	PUKL SHF	PUKL Total
Assets		3,017	305	3,322
Liabilities				
	Conventional non-profit	641	0	641
net of reinsurance	Index linked	2,264	0	2,264
	Sub total	2,905	0	2,905
	Other	90	0	90
	Total liabilities	2,995	0	2,995
Excess Assets		22	305	326
CRR				126
Excess Assets after CRR				200

3. Pillar I solvency ratios for RLL and PUKL prior to the transfer

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

Notes:

1. Assets = Long-term insurance fund assets + SHF net assets.
2. Excess assets do not take account of the CRR.

APPENDIX 2 – PRO FORMA FINANCIAL POSITION POST-TRANSFER AS AT 31 DECEMBER 2010

The figures in the tables below show the pro forma financial position of RLL as at 31 December 2010 assuming the transfer had taken place on this date. The figures shown are net of reinsurance.

1. RLL

RLL		£m		
31 December 2010		RLL LTF	RLL SHF	RLL Total
Assets		4,152	360	4,511
Liabilities				
	Conventional non-profit	717	0	717
	Index linked	2,898	0	2,898
	Sub total	3,615	0	3,615
	Other	408	0	408
	Total liabilities	4,023	0	4,023
Excess Assets		129	360	488
CRR				173
Excess Assets after CRR				316

2. Pillar I solvency ratio for RLL after the transfer

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

Notes:

1. Assets = Long-term insurance fund assets + SHF net assets.
2. Excess assets do not take account of the CRR.

APPENDIX 3 – RECONCILIATION OF THE RESTATED PUKL FINANCIAL POSITION AS AT 31 DECEMBER 2010

The financial position of PUKL changed fundamentally after 31 December 2010 as a result of the acquisition by Goldman Sachs.

The table below compares the published PUKL position as at 31 December 2010 with the re-stated position allowing for the post-31 December 2010 changes.

1. PUKL reconciliation overview

PUKL		£m		
31 December 2010		Published	Re-Stated	Difference
Assets		3,053	3,017	-36
Liabilities				
(net of reinsurance)	Conventional non-profit	641	641	0
	Index linked	2,265	2,264	-1
	Sub total	2,906	2,905	-1
	Other	90	90	0
	Total liabilities	2,996	2,995	-1
LTF capital resources		57	22	-35
SHF net assets		195	305	110
CRR		118	126	8
Excess Assets after CRR		134	200	67

2. Change in LTF asset position

PUKL	£m
Total Return Swap asset trading adjustment	-56
Asset pricing adjustment	-30
Transfer from SHF	50
Change in value of LTF assets	-36

Notes:

1. TRS trading adjustment = a market value adjustment to the value of the bonds applied to cover the costs of implementing the TRS
2. Asset pricing adjustment reflects changes in pricing sources used

3. Change in SHF asset position

PUKL	£m
Capital injection from RLL	160
Transfer to LTF	-50
Change in value of SHF assets	110

4. Change in total liabilities

PUKL	£m
Reduction in expense reserve	-49
New mortality improvement factors	60
New margin for adverse deviations on base mortality tables	10
New married proportion shock	-4
Change in reinsurance adjustment due to lighter mortality assumptions	-2
Increase in VRI due to introduction of Total Return Swap	-13
Removal of CFMMR	-3
Change in mathematical reserves	-1

Notes:

1. Expense reserves have reduced reflecting the ability of PUKL to share the expense base with RLL
2. Base mortality improvement year moved from 2003 to 2000

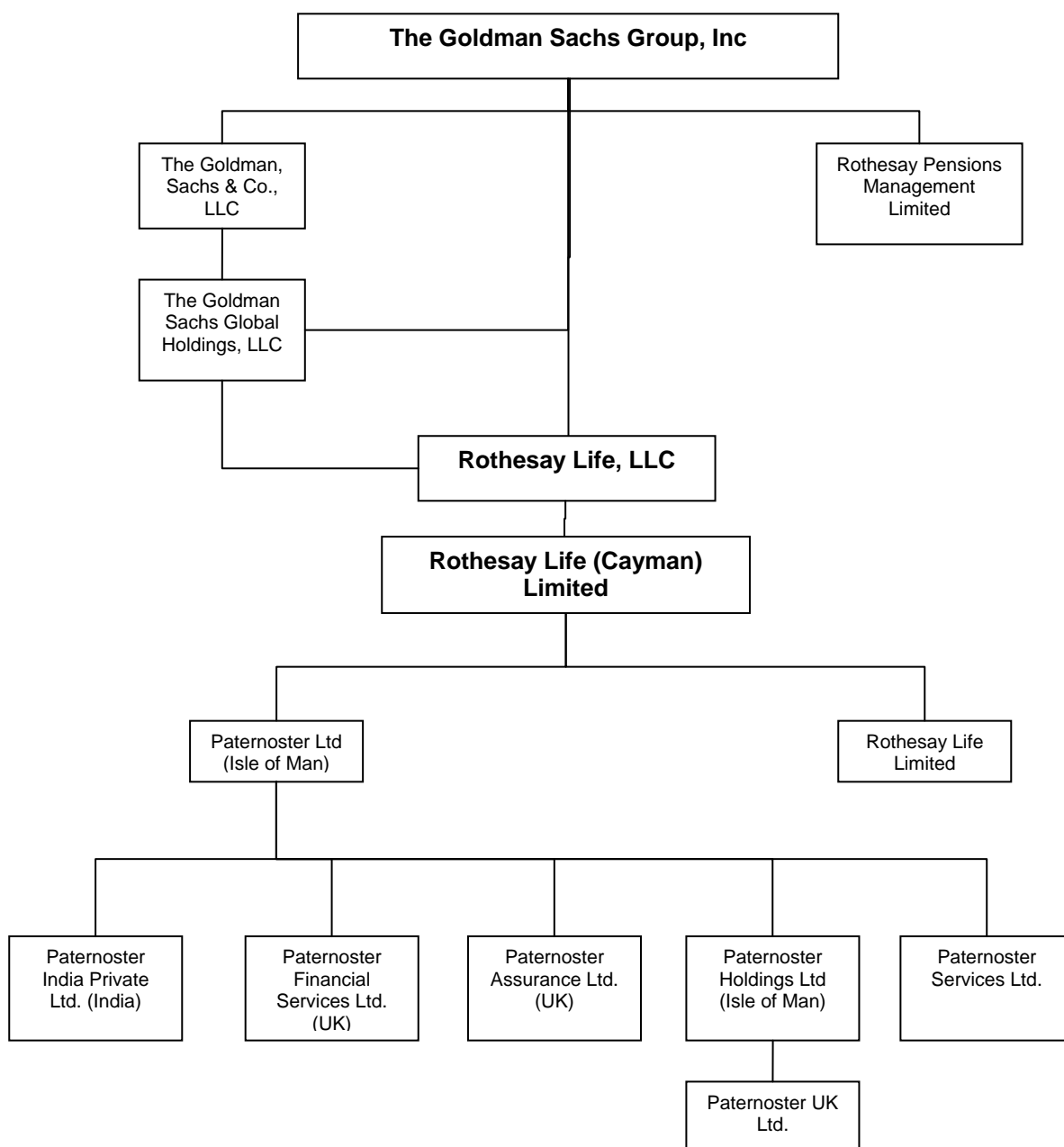
3. qx shock used for base mortality table margin moved from 5% to 6%
4. Married proportion shock moved from 7.5% multiplicative to 5% additive
5. Valuation rate of interest (VRI) increased from 4.79% to 4.83%
6. CFMMR is cashflow mis-matching reserve

Change in CRR

The RCR increased by £7m due to the expenses cashflows no longer being hedged.

APPENDIX 4 – ORGANISATIONAL CHARTS

Chart 1: The Goldman Sachs Group, Inc



Source: RLL Part VII Information Pack

NB: A number of companies which are not financially significant relative to other Goldman Sach's business are not shown in the diagram above

Chart 2: RLL

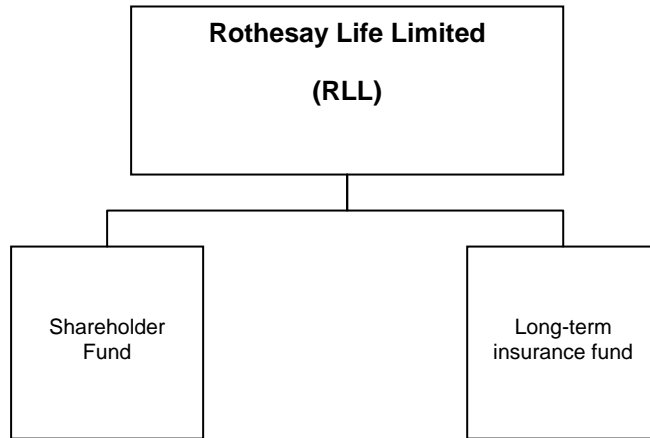
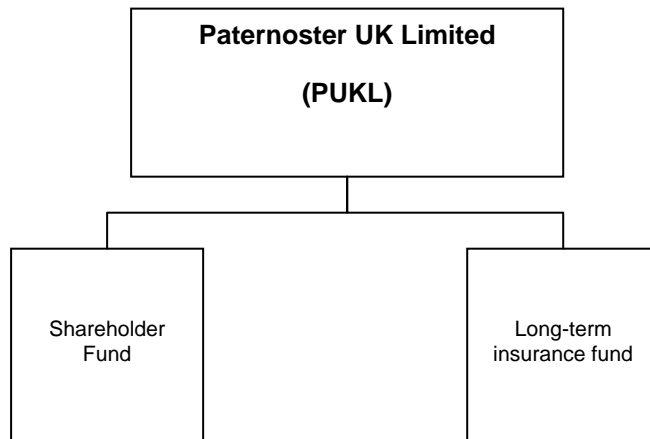


Chart 3: PUKL



APPENDIX 5 – 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 the following:

1. Scheme documents
 - Scheme document
 - First Witness Statement document
 - Part VII Information Pack – April 2011
 - Instructions to Counsel – 14 April 2011
2. RLL
 - AFH report on the proposed transfer – Report on the Proposed Insurance Business Transfer Scheme Relating to the Transfer of Business of Paternoster UK Limited to Rothesay Life Limited
 - RLL FSA Returns for 2010 year end
 - RLL Directors' Report and Financial Statements for 2010 year end
 - RLL ICA for 31 August 2010
3. PUKL
 - AFH report on the proposed transfer – Report on the proposed Part VII Transfer from Paternoster UK Limited to Rothesay Life Limited
 - PUKL FSA Returns for 2010 year end
 - PUKL Annual Report and Financial Statements for 2010 year end
 - PUKL FSA Individual Capital Assessment Review – letter to Ed Jervis from the FSA dated 6 January 2011
 - Restated financials for PUKL as at 2010 year end restated to allow for the various financial transactions that took place after 31 December 2010 in relation to the purchase of PUKL by RLL. This is as shown in Appendix 3 of this report.
4. Other
 - Solvency II analysis of RLL and PUKL pre and post transfer.
 - Total Return Swap documents – various memos from Goldman Sachs to Paternoster UK dated 31 March 2011

APPENDIX 6 – TERMS OF REFERENCE

Scope of the work of the Independent Expert in relation to the Scheme

My report is to consider the terms of the Scheme generally and the effect which the Scheme will have on the different groups of policyholders, including, for the avoidance of doubt, the policyholders of Paternoster and Rothesay Life. The definition of 'policyholder' is to be agreed with the FSA.

In particular my report will consider the following specific matters:

- The impact of the Scheme on the security of benefits of the different groups and generations of policyholders involved in the Scheme;
- The risks to which Paternoster and Rothesay Life policyholders will be exposed as a result of the transfer;
- The impact of the Scheme on the capital available to provide support to the transferring policyholders and the existing policyholders of Rothesay Life;
- The proposed communications with policyholders concerned in the Scheme;
- The adequacy of any safeguards in the Scheme for the different groups and generations of policyholders involved in the Scheme;
- How the application of management discretion (if any) that is embedded in the current policies would be affected by the transfer;
- The impact of the Scheme on existing service levels and agreements; and
- Any other matters brought to my attention by the FSA.

The review and report will address generally the way in which the Companies have conducted their long term business but taking into account the particular circumstances of each class of insurance business to be transferred. It will deal inter alia with the following aspects of the Companies:

- Memorandum, and the Articles of Association, at least insofar as these affect the rights, expectations and interests of policyholders;
- Reserving, capital and security;
- The terms of the policies issued by the Companies;
- The Companies' reinsurance agreements;
- Any service, or other relevant, agreements with intra-group companies;
- The existing and proposed internal working arrangements relating to the financial management of the long term business fund, including the operational and administrative arrangements which will apply to the business to be transferred under the terms of the insurance scheme;
- Promotional or marketing materials (including those documents issued under the Financial Services and Markets Act 2000 and previous compliance regimes) which would influence the reasonable expectations of policyholders
- The terms and conditions expected to be imposed by the Scheme to be presented to the Court, including the views expressed by the governing body or management of the Companies; and,
- The terms of any previous Schemes of transfer concerning the policyholders of the Companies.

The above list is not intended to be exclusive to any other aspects which may be identified during the completion of the project and which are considered to be relevant.

I shall not be directly involved in the formulation of the proposed transfer although I should expect to give guidance during the evolution of the detailed proposals on those issues which concern me, or which I consider unsatisfactory.

APPENDIX 7 – STATEMENT OF INDEPENDENCE

Introduction

Paternoster UK Limited (“Paternoster”) has proposed me to act as the Independent Expert in respect of a proposed scheme under Part VII of the Financial Services and Markets Act 2000 to transfer the long term business of Paternoster to Rothesay Life Limited (“Rothesay Life”).

I am a Principal of Milliman Limited and I am based in its UK Life Insurance practice in London. I am a Fellow of the Institute and Faculty of Actuaries which was established in 2010 by the merger of the Institute of Actuaries and the Faculty of Actuaries. I became a Fellow of the Institute of Actuaries in 1999.

I am not a shareholder in Paternoster, Rothesay Life Group, or Goldman Sachs or any subsidiaries thereof.

I hold no individual policies with any of the companies within Paternoster or Rothesay Life Group.

I am not a member of any of the pension schemes under the management of Paternoster or Rothesay Life.

Milliman work with Paternoster or Rothesay Life

Milliman has not done any previous work for Paternoster or Rothesay Life.

Other work for Goldman Sachs

Milliman in London carried out no work for Goldman Sachs in 2010 and is not currently carrying out any work for Goldman Sachs.

Milliman is a global consulting firm and as such, Milliman has worked with Goldman Sachs in 2010 and 2011 in New York. The total fees for the work for Goldman Sachs represent less than 0.1% of Milliman's revenues.

Milliman has strict rules around confidentiality and data control. Milliman's different regional practices enjoy a high degree of independence and autonomy from each other in both logistical and financial terms. Therefore the work done in the US is of minimal financial relevance to me and to the UK Life practice and so will have no effect on my work.

I do not believe that any of the above adversely affects my ability to act independently in my assessment of the Scheme.

Oliver Gillespie

3rd March 2011

Fellow of the Institute and Faculty of Actuaries