



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

Ernst & Young LLP

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1. Background and context

The purpose of this report is to update the previous report produced by Ernst & Young and signed by me in my capacity as Actuarial Function Holder for Paternoster UK Limited on 14 July 2011. Since the previous report was produced, updated numbers have become available as at end September 2011. This report also comments on business and other changes since the previous report and comes to an updated conclusion.

The purposes of the original report were to:

- ▶ describe the proposed insurance business transfer scheme (the 'Scheme') as defined in Part VII of The Financial Services & Markets Act 2000 ('FSMA') relating to the transfer of the long-term insurance business of Paternoster UK Limited ('Paternoster') to Rothesay Life Limited ('Rothesay'), and
- ▶ consider the impact of the proposed Scheme on the benefit expectations of the existing policyholders of Paternoster at the date of transfer, the future security of these benefits and the principles to treat customers fairly and manage conflicts of interest fairly.

This update report has been prepared for the Board of Directors of Paternoster in response to a request for such a report by the Board.

A separate update report has been prepared by Towers Watson in relation to their duties to Rothesay. Therefore, I have not explicitly considered the implications of the Scheme for the policyholders of Rothesay.

Rothesay has provided us with the relevant updated financial information at 30 September 2011.

This updated report has been prepared subject to the same reliances and limitations as set out in the previous report dated 14 July 2011 and Section 5 of this updated report.

2. Updated financial position as at 30 September 2011

The table below sets out the pro forma Pillar 1 financial position of Paternoster (restated) and Rothesay before and after the transfer, assuming that the transfer had become effective on 31 December 2010.

Table 2.1 Pillar 1 position at 31 December 2010

£m	Paternoster (pro forma*)	Rothesay	Combined entity post Part VII
Value of assets	2,927	818	3,745
Net liability	(2,905)	(710)	(3,615)
Surplus in long-term fund	22	107	129
Assets in Shareholder fund	305	55	360
Total surplus	326	162	488
Capital requirement	(126)	(46)	(172)
Free assets	200	116	316
CRR cover	259%	350%	283%

* The Paternoster pro form numbers are restated from the actual 31 December 2010 position to reflect the restructuring that took place in January 2011 when Goldman Sachs had complete their acquisition.

Numbers have been rounded to £(m) above, so do not always add up due to small rounding differences

Table 2.2 below sets out the pro forma Pillar 1 financial position of Paternoster and Rothesay before and after the transfer, assuming that the transfer had become effective on 30 September 2011.

It should be noted that the capital position in the combined entity is higher at 288% than Paternoster on a stand-alone basis.

Table 2.2 Pillar 1 position at 30 September 2011

£m	Paternoster	Rothesay	Combined entity post Part VII
Value of assets	3,107	1,022	4,129
Net liability	(3,037)	(916)	(3,953)
Surplus in long-term fund	70	106	176
Assets in Shareholder fund	305	55	360
Total surplus	375	161	536
Capital requirement	(131)	(55)	(186)
Free assets	244	106	350
CRR cover	286%	295%	288%

Numbers have been rounded to £(m) above, so do not always add up due to small rounding differences

I have also reviewed the pro forma Pillar 2 (ICA) position of both businesses before and after the transfer (as if the transfer had become effective on 30 September 2011). Currently, both Paternoster and Rothesay are Pillar 1 companies. Given the asset strategy of both businesses (i.e. no significant outright credit risk), this is not unexpected.

On a Pillar 2 basis, I consider that the combined entity free asset ratio is adequate and does not materially impact the security of the Paternoster policyholders.

Although I have not been provided with detailed calculations of the financial position since 30 September 2011, I have been provided with the key sensitivities, particularly to equity market and interest rate movements, which demonstrate that the capital cover ("CRR cover" in table 2.2) is unchanged for both Paternoster and Rothesay by any movement in equity markets, and for movements of 100 basis points in interest rates, the capital cover is likely to remain above 275% for both Paternoster and Rothesay.

3. Changes since previous report

3.1 Business changes

This section summarises changes within either of Paternoster or Rothesay since my original report was produced.

3.1.1 Longevity swaps

With effect from 1 July 2011, Paternoster has entered into a new reinsurance arrangement with RGA to “lock in” the assumed longevity experience on a proportion (approximately 46%) of a defined block of business. Under this arrangement Paternoster has committed to pay a pre-determined (regular) premium for this block of business on an ‘expected’ mortality basis and will receive (regular) claim payments from RGA that will reflect the actual future mortality basis for this same block of business. The arrangements include provisions for the regular movement between the parties of eligible collateral to minimise the counterparty credit exposures of both parties.

Since 30 September 2011, Paternoster 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 is smaller in size. This deal will have a positive effect on the Pillar 1 and Pillar 2 financial position of Paternoster.

3.1.2 Other asset transactions

On 21 July 2011, Paternoster entered into a series of secured funding transactions totalling £1 billion which replaced part of an existing Total Return Swap (TRS) transaction, so that the revised aggregate position remains identical to the maturity and notional profile under the original TRS. Although the financial terms were not materially different to the original TRS terms, the overall position for Paternoster is slightly improved because the collateral posted under the new structure is being independently verified by a third party and is subject to slightly larger ‘haircuts’ (i.e. more collateral is being received by Paternoster) than under the TRS.

3.1.3 Other business changes

I have had discussions with management regarding a number of other potential transactions which Rothesay and Paternoster may enter into in the normal course of their business prior to the transfer. I have reviewed the effect that these potential transactions could have on both companies when considered individually and in aggregate.

I have been provided with the pro-forma financial impact of each of these transactions, which may or may not be completed. If certain of these transactions are completed, they have the potential to reduce excess assets in the post transfer company. However, given the capital policy in place, management have noted that either further reinsurance transactions or additional capital will be provided if needed to maintain capital levels under the agreed policy.

I am satisfied that, should new business be written on materially the same terms as management have suggested, the conclusions made in Sections 2 and 6 of my main report and in section 4 of this updated report still apply.

Other than the issues identified in section 3.1, I am not aware of any other changes to the business model since my previous report, and so I conclude that none of these changes would invalidate my previous and current conclusions.

3.2 Regulatory changes

I set out below the main changes in regulation, including draft proposals published in e.g. Consultative Papers, and give my opinion on their likely impact.

3.2.1 Solvency II regulation

There has been no material change to draft regulations which would invalidate my previous and current conclusions.

It should be noted, however, that there still remains uncertainty about certain aspects of Solvency II methodology which may be material to both Paternoster and Rothesay. The final methodology for 'matching premium' is a particularly relevant example of an area where this uncertainty exists. However, as the businesses of both Paternoster and Rothesay separately, and of the combined business together, are very similar, this uncertainty does not materially change the position of either of the firms before or after the proposed Part VII transfer.

3.2.2 FSA regulation

The FSA published a consultative paper GC11/18 in July 2011 with comments to be received by 21 September 2011. This dealt with what they called 'liquidity swaps' and considers the appropriateness of certain financial transactions characterised by insurers swapping liquid assets for more illiquid assets. e.g. total return swaps with relatively illiquid collateral.

No policy proposals have yet been published arising from this consultation, although FSA have stated that they are inclined to the view that intra-group transactions are unlikely to be able to meet conflicts of interest tests and as a result, such transactions should generally be avoided.

Paternoster does have exposure to intra-group arrangements (as well as other equivalent arrangements with third parties on an arms-length basis) and only entered into these transactions following detailed discussion and no objection at the time from the FSA. Furthermore, the consultation is silent about what grand-fathering treatment may be available to firms if any future regulation is implemented consistently with the consultative paper

However, I note that this may become an issue for Paternoster to manage anyway were the transfer not to proceed, and this potential situation is not worsened for Paternoster policyholders should the Part VII transfer proceed.

3.2.3 Professional regulation – actuarial standards

Since the previous report was produced on 14 July 2011, two new Technical Actuarial Standards (TASs) published by the Board for Actuarial Standards (BAS) have (from 1st October 2011) become effective that are of relevance and the requirements of which are reflected in this report. These are the Insurance TAS and the Transformations TAS. In addition, two new Actuarial Practice Standards (APSs) published by the Institute and Faculty of Actuaries have also become effective from 1st October 2011 that are of relevance, being APS L1 and APS L2.

There are no new and material issues arising from these TASs and APSs which were not already being addressed by the actuarial standards then applying to the previous report, as this fell into the "Required Work" category as prescribed by BAS, so this report has been prepared in accordance with these standards.

3.2.4 Other regulation

On 4 October 2011 the Council of the European Union (ECOFIN) published its position with a view to negotiations with the European Parliament on a draft regulation aimed at increasing transparency and reducing risk in the over-the-counter (OTC) derivatives market on OTC derivatives (document reference 15148/11). The draft regulation calls for reporting of all derivative contracts to trade repositories (i.e. central data centres) and the clearing of standardised OTC derivative contracts through central counterparties (CCPs) in order to reduce counterparty risk (i.e. the risk of default by one party to the contract). This is aimed at preventing the default of one market participant causing the collapse of other market players, thereby putting the entire financial system at risk. To be authorised, a CCP would, inter alia, have to hold a minimum amount of capital. The draft regulation is aimed at implementing

commitments made by G-20 leaders in September 2009 and is intended to apply from the end of 2012.

Although Paternoster does hold OTC derivatives to closely match its obligations to policyholders, I do not currently expect this proposed regulation to have any materially different impact on the business of the combined Paternoster / Rothesay entity compared to the business of Paternoster as a separate stand-alone business.

3.3 Other issues – consideration of policyholder enquiries

I have been provided with correspondence with policyholders in connection with the proposed transfer. At the time of writing, there have been very few enquiries from policyholders. However, should material matters arise which I believe are not adequately addressed in my reports, I will issue a further supplemental report ahead of the Court sanctions hearing.

One enquiry specifically requested further information regarding how the Scheme may affect the fair treatment of policyholders, in particular in respect of the fact that different policies have different features which, as was mentioned in the Independent Expert's main report, allow certain policyholders the right, under very specific circumstances, to surrender their policies.

In addition, Rothesay has been asked to comment upon the nature of certain charges which it has granted policyholders and which are lodged with Companies House.

In considering the Scheme, I have specifically considered options and guarantees that may be contained within policies that both Rothesay and Paternoster have written. It is quite normal for life insurers to have underwritten policies which contain different features and I referred to these features in my main report.

When considering the fair treatment of customers and the impact that the proposed Scheme may have on policyholders, I have reviewed the different features that are contained within the policies that both companies have underwritten. Specifically, I have considered whether any of the terms within these policies would, either now or in the future, give rise to any unfairness as a result of policyholders, in certain circumstances, exercising options to surrender their policies. As part of these considerations, I have considered the likelihood that these options will become exercisable and also the adequacy of capital either implicitly or explicitly supporting these policies.

Having reviewed the terms of these policies and considered the capital supporting both businesses, I am satisfied that Paternoster policyholders will not be materially adversely affected by the proposed Scheme.

I have also reviewed the details regarding charges which Rothesay has granted to certain policyholders and which are lodged at Companies House. I understand that the accounts which have a charge over them currently have only nominal sums within them and have been established as part of a structure which allows Rothesay, in certain circumstances, to secure assets in respect of premiums which may become due to it from policyholders.

I am, therefore, satisfied that these charges are part of a wider structure which adds to the security of other policyholders and will not have an adverse affect on the Scheme.

4. Conclusion

4.1 Technical Actuarial Standards - conclusion

This report complies with Technical Actuarial Standard (TAS) R: Reporting Actuarial Information as its intended purpose is to describe the proposed insurance business transfer scheme and to consider the impact of the proposed Scheme on the benefit expectations of the existing policyholders of Paternoster at the date of transfer, the future security of these benefits and the principles to treat customers fairly and manage conflicts of interest fairly.

In addition to complying with TAS R, I can confirm that there have been no material departures from any of the other TASs in performing this work, particularly the newly implemented Insurance TAS and the Transformations TAS.

4.2 Changes to conclusion since previous report

I can confirm that I have no reason to change the conclusions reached in my previous report of 14 July 2011.

4.3 Summary of conclusions

In the light of the considerations set out in this report and my previous report of 14 July 2011, I continue to conclude that:

- ▶ the security of Paternoster's policyholders is not likely to be adversely affected by the proposed transfer;
- ▶ the reasonable benefit expectations of Paternoster's policyholders are not likely to be adversely affected by the proposed transfer;
- ▶ there will be little or no impact on the administrative arrangements applicable to Paternoster's policyholders as a result of the proposed transfer;
- ▶ there are no features of the Scheme that appear to breach either of the Principles to treat customers fairly or manage conflicts of interest fairly; and
- ▶ there are no features of the Scheme that appear likely to prejudice Court approval of the Scheme.

5. Reliance and limitations

5.1 Reliance

In carrying out this review and producing this report, I have relied without independent verification upon the accuracy and completeness of data and information provided to us, both in written and in oral form, by Paternoster and Rothesay and their advisers.

Reliance has been placed upon but not limited to the following data and information:

- ▶ the data and information provided to us as described in my previous report of 14 July 2011;
- ▶ unaudited financial statements of Paternoster and Rothesay as at 30 September 2011; and
- ▶ information relating to the commercial transactions of Paternoster and Rothesay during the 2011 calendar year up until the date of this report.

5.2 Limitations

This report has been prepared on an agreed basis to meet the specific purposes of Paternoster and must not be relied upon for any other purpose. The same limitations apply to this report as applied in my previous report of 14 July 2011 and this report should be read in conjunction with that report.



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18 November 2011