

Report on Proposed Part VII Transfer from
Paternoster UK Limited to Rothesay Life
Limited

14 July 2011

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1. Introduction

The purpose of this report is 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 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 report has been prepared by Towers Watson in relation to their duties to Rothesay. Therefore, we have not explicitly considered the implications of the Scheme for the policyholders of Rothesay.

2. Executive summary

The main terms of the proposed Scheme are as follows:

- ▶ Paternoster will transfer its business, including (so far as it is possible) all of its assets and liabilities to Rothesay.
- ▶ Policies of Paternoster will, once the proposal takes effect, become policies with Rothesay, meaning that any policyholders or claimants in respect of these policies will be policyholders or claimants respectively of Rothesay following the transfer, and
- ▶ The Scheme contains provisions setting out how the policies, assets and liabilities being transferred will be allocated within Rothesay.

It is currently expected that the Scheme will be implemented on 14 December 2011, provided that all the conditions have been satisfied or waived.

In the light of the considerations set out in this report, I have concluded 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 me 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 to me likely to prejudice Court approval of the Scheme.

3. Background to companies involved and proposed scheme

3.1 Paternoster UK Limited

3.1.1 Historical financial position

Paternoster was authorised in June 2006, as an FSA regulated insurance company focused exclusively on the UK defined benefit pension risk transfer market after the parent company, Paternoster Limited, had raised £500m in equity capital from a range of financial investors.

Upon gaining regulatory approval, Paternoster agreed its first scheme in 2006 before going on to complete a total of 42 transactions by September 2008, writing cumulative premium income of £2.7bn. These transactions ranged in size from under £1m to over £800m and were conventional single premium bulk annuities.

Generally, the liabilities to policyholders are for the payment of guaranteed annuity amounts, which are payable on either an immediate or a deferred basis, and either during the lifetime of the original pension scheme member or to his or her dependant(s) on a contingent basis. Where the trustee policyholders affect a buy-out of a pension scheme's liabilities, the bulk policy can be surrendered by the trustees in return for individual policies which the trustee can then assign to the member by way of discharging their obligations to the scheme members. Individual deferred annuities may be surrendered (i.e. transferred to another registered pension scheme) in which case a transfer value would be payable on terms calculated on a contractually defined basis.

One 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 of Paternoster would increase.

Paternoster also has a commitment to two schemes to offer annuities with pre-set longevity and expense assumptions to a defined group of members should they reach retirement. For the larger scheme, this commitment lapses in February 2012 and could result in additional premium, taking a reasonable upper bound of c. £12m if all eligible lives took up the option, with £3m for the smaller scheme.

The following table shows the key financial metrics of Paternoster (as taken from the annual returns to the FSA):

Table 3.1.1 Development of Key Metrics - Paternoster

£000s	2006	2007	2008	2009	2010
Net earned premium	122,326	1,429,018	1,124,321	20,160	1,203
Mathematical reserves	145,269	1,636,124	2,579,538	2,738,307	2,905,645
Additional capital resources	49,936	202,689	213,335	288,588	251,743
Capital resource requirement (CRR)	8,439	83,144	115,881	123,132	118,328
Free assets	41,497	119,545	97,454	165,456	133,415
CRR cover	592%	244%	184%	234%	213%
Number of scheme insured (cumulative)	8	21	42	42	42

Paternoster adopted an asset strategy whereby it invested in long dated corporate credit (with appropriate interest rate and inflation swaps). As a consequence of the financial crisis and an increased reserving requirement, Paternoster had insufficient capital on a Pillar 2 basis to continue to write new business. Consequently, it took the decision in April 2009 to request the removal of its permission to write new business and entered into a period of retrenchment whilst it evaluated its options.

Following an evaluation of options it was decided to embark upon a process to raise additional capital with the likelihood that such capital raising could result in the outright sale of the business.

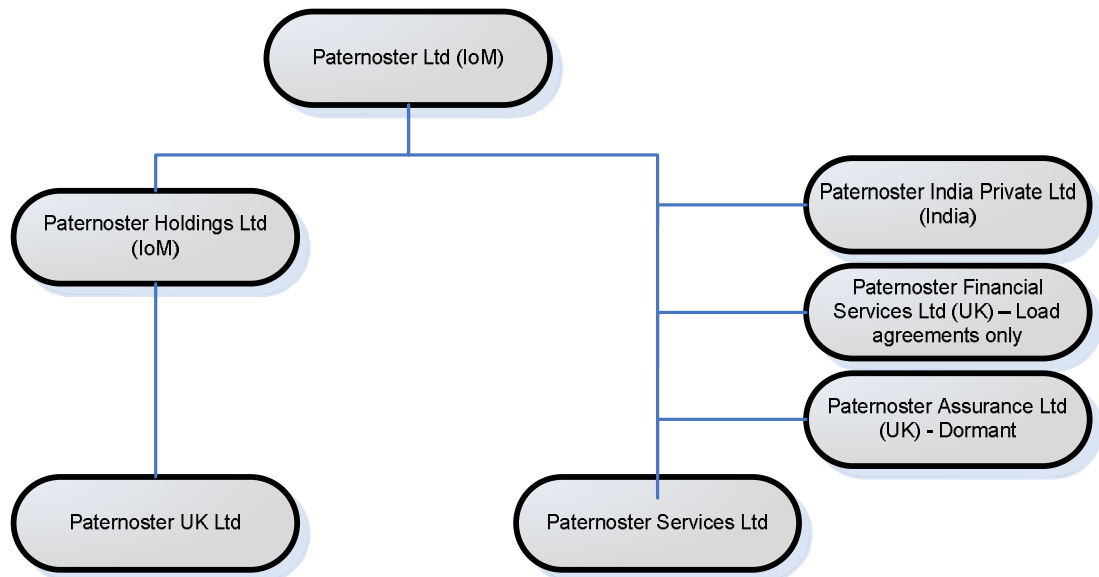
3.1.2 Group structure

Paternoster Services Ltd provided all of the Paternoster based services, including business development, operations activities, and management personnel for pricing, investment, mortality, and financial divisions. In addition, in April 2010, Paternoster was FSA approved to provide intermediary insurance activities. This supported the development of the group’s introductory services in the emerging longevity swap market whilst the insurance entity was unable to participate directly in the market.

Paternoster India Private Ltd provided Paternoster with technical pricing, investment, finance and mortality analytical services.

Paternoster Financial Services Limited provides tax efficient intra-group financing. Specifically, the company acts as intermediary between Paternoster Limited and Paternoster UK Ltd in respect of the contingent loan facility entered into in August 2008.

The overall structure can be summarised as follows :



3.2 Rothesay Life Limited

3.2.1 Historical financial position

Rothesay is a wholly owned subsidiary of Goldman Sachs Inc and was authorised in 2007. It completed its first deal in 2008 and has gone on to write five further transactions.

Unlike Paternoster, these transactions are more varied in nature. They are generally larger in size than those of Paternoster and include conventional annuities, collateralised buy-ins and longevity swaps.

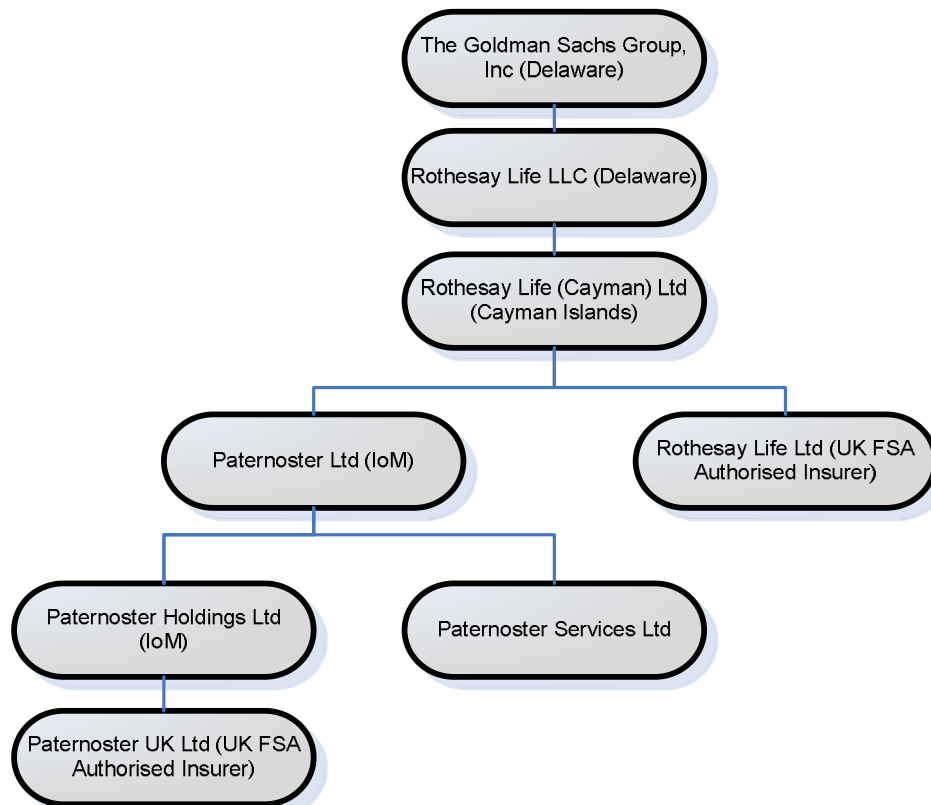
Rothesay has also made extensive use of the reinsurance market with approximately 80% of the longevity risk being transferred to the third party reinsurance market, via 4 counterparties. Unlike Paternoster’s previous asset strategy, Rothesay takes very little outright credit risk, using credit derivatives to hedge out this risk.

Table 3.2.1 Development of Key Metrics - Rothesay

£000s	2007	2008	2009	2010
Net earned premium	3,000	437,097	388,498	94,331
Mathematical reserves	-	352,302	700,995	710,494
Additional capital resources	8,918	65,390	71,997	161,949
Capital resource requirement (CRR)	2,139	28,454	26,603	46,239
Free assets	6,779	36,936	45,394	115,710
CRR cover	417%	230%	271%	350%
Number of scheme insured (cumulative)	-	1	4	6

3.3 Acquisition of Paternoster UK Limited

On 11 January 2011, Rothesay (Cayman) Limited acquired 100% of the share capital of Paternoster UK. At that time, in order to expedite a change of control approval from the FSA, £60m of additional equity and £100m of subordinated debt was injected into Paternoster. Following the acquisition, the group structure was as follows:



Immediately following the acquisition, Paternoster entered into a collateralised total return swap which had the effect of swapping the variable return associated with its bond portfolio for a fixed return designed to match a prudent expectation of future cashflows. By entering into this contract, Paternoster removed the spread risk associated with its c. £3bn bond portfolio and adopted an asset strategy that is now materially the same as that being utilised by Rothesay.

4. Outline of Scheme

Further to the acquisition of Paternoster, the Boards of both Rothesay and Paternoster agreed to begin the process for merging the two operations through a transfer of Paternoster's business to Rothesay under Part VII of FSMA.

The purpose of the proposed Scheme is to merge two insurers that are both now owned by Goldman Sachs that have effected and carry out broadly the same type of business with the same type of customers.

The Scheme is not intended to make any changes to policy contracts other than those that are purely consequential on the transfer process, although there remains the possibility that discussions with trustee policyholders could result in amendments to policies ahead of the transfer. I am not aware that any of the liabilities to Paternoster or Rothesay policyholders are being materially changed as a result of the proposed Scheme.

From an operational perspective, both businesses have already been integrated and are subject to the same processes, governance and control. However, a transfer under Part VII will achieve the following further objectives:

- ▶ Reduced administrative costs (e.g. producing and auditing one set of accounts, ICA, FSA returns, customer documentation, website etc)
- ▶ One set of Solvency II models and approvals
- ▶ Simpler and clearer customer communication
- ▶ Increased diversification of risks and consequent improvements to capital efficiency

Under the proposed Scheme, it is intended to transfer all of the assets and liabilities of Paternoster to Rothesay. As a consequence all of the obligations and contracts which are associated with Paternoster will transfer to Rothesay including associated reinsurance, service agreements and swap contracts.

Although the Scheme has provisions for the possibility of some assets and liabilities to be transferred after the main transfer date, I understand that these are expected to be small or non-existent and other provisions in the Scheme are intended to transfer as much of the economic effect as possible of such assets and liabilities to Rothesay as at the main transfer date.

From a policyholder perspective, all existing administration arrangements will remain in place and JLT (who are the third party admin provider for Paternoster) will continue to operate as before. Similarly, there will be no changes to the existing services provided by Towers Watson (who are the third party admin provider for Rothesay).

Communication of the Part VII transfer is to Trustee policy-holders and to individuals who are entitled to benefits under individual policies of insurance.

5. Financial position of Rothesay post transfer

5.1 Pro forma position as at 31 December 2010

Both as a result of the acquisition and as a result of transactions entered into by Paternoster following its acquisition, the financial position of Paternoster fundamentally changed shortly after the financial year end. Therefore, in order to provide more meaningful financial information, a pro forma balance sheet has been prepared which represents a year end position for Paternoster but reflecting the following changes:

- ▶ A capital injection of £160m (£60m equity and £100m subordinated debt)
- ▶ The completion of a total return swap (TRS) locking into a return for the full term of the liabilities
- ▶ An expense reserve release reflecting the efficiencies of the shared cost base, and
- ▶ Alignment of longevity assumptions with those of Rothesay.

In the sections below, we consider the movements in the Paternoster's mathematical reserves, value of assets in both the Long-term Business Fund and the Shareholders' Fund, following the adjustments set out above, culminating in the calculation of the restated free assets.

5.1.1 Movement in mathematical reserves

The table below shows the impact of the above adjustments on the mathematical reserves of Paternoster as at 31 December 2010, assuming that the transaction and other changes noted above had taken place.

Table 5.1.1 Breakdown of movement in Paternoster's mathematical reserves as at 31 December 2010

	£m
Reported mathematical reserve (see section 3.1.1 above)	2,906
New expense reserve	(49)
New mortality improvement factors (best estimate and prudent)	60
New valuation margin for adverse deviation (MAD) on base mortality tables (5% qx shock moved to 6% qx shock)	10
New married proportion (5% additive rather than 7.5% multiplicative)	(4)
Change in reinsurance adjustment due to lighter mortality assumptions	(2)
TRS impact on Valuation Rate of Interest (VRI changed from 4.79% to 4.83%)	(13)
Removal of cash flow Mis-Match Reserve	(3)
Total impact on mathematical reserves	(1)
Restated mathematical reserves	2,905

Additionally, the Resilience Capital Requirement (RCR) increased by £7m as a result of the stated adjustment due to expense cashflows which are no longer being hedged.

We note the following in terms of the table above:

Expenses

Paternoster held significant expense reserves due to the position of the company. Post transaction, the expenses have been reduced to reflect the ability to share the expense base with Rothesay.

Demographic assumptions

For Paternoster, the monthly reporting on mortality and married proportion supports that the best estimate basis is appropriate for the Paternoster book and as such the base assumptions remain unchanged from those used at the year end. However the level of prudence has been adjusted to be the same as used for Rothesay, moving the qx MAD from 5% to 6% and changing from a 7.5% multiplicative married proportion assumption to 5% additive.

Mortality improvements have been adjusted on both a best estimate and valuation basis. This is due to not being able to evidence appropriate best estimate improvement assumptions in the same way as with base mortality. The change in assumptions is as follows:

Table 5.1.2 Paternoster's original and restated mortality improvement assumptions

Mortality improvement assumptions	FSA Return valuation basis	Restated valuation basis
Male	Males: CMI 2010 [1.8%]	Males: 50% MC, 50% LC, 1.7% floor
Female	Females: CMI 2010 [1.6%]	Females: 100% MC 1.7% floor

Introduction of total return swap

A total return swap (TRS) has been implemented to remove the credit risk from Paternoster's asset portfolio. This is a full term TRS which is a fairly good match to the Pillar 1 liabilities. The return is locked in leading to a valuation interest rate of 4.83%, which is marginally higher than the previous valuation interest rate at 31 December 2010.

5.1.2 Movement in assets in the long-term fund

The table below shows the impact of the above adjustments on the value of the assets in the Long-term Business fund of Paternoster as at 31 December 2010, assuming that the transaction had taken place.

Table 5.1.3 Breakdown of movement in Paternoster's asset in the Long-term Business Fund as at 31 December 2010

	£m
Reported value of assets in the Long-term Business Fund	2,963
TRS asset trading adjustment	(56)
Asset pricing adjustment	(30)
Shareholder transfer	50
Restated value of assets in the Long-term Business Fund	2,927

5.1.3 Movement in assets in the Shareholders fund

The table below shows the impact of the above adjustments on the value of the assets in the Shareholders' Fund of Paternoster as at 31 December 2010, assuming that the transaction had taken place.

Table 5.1.4 Breakdown of movement in Paternoster's assets in the Shareholders' Fund as at 31 December 2010

	£m
Reported value of assets in the Shareholders' Fund	195
Injection from Rothesay	160
Transfer to the Long Term Business Fund	(50)
Restated value of assets in the Shareholders' Fund	305

5.1.4 Summary

In summary, these changes have resulted in an improvement in the Pillar 1 financial position of Paternoster relative to its published FSA Return position, as set out in section 3.1.1 above, with assets in excess of its Pillar 1 Capital Resource Requirement (CRR) increasing from just over £133m to £200m, and with the CRR coverage ratio increasing from 213% to 259%.

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. It should be noted that the capital position in the combined entity is higher still at 283%.

Table 5.1.5 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
LTICR	(116)	(30)	(146)
RCR	(10)	(17)	(27)
Free assets	200	115	316
CRR cover	259%	345%	283%

5.2 Subsequent events

Apart from topics noted in section 5.1 above, there are three other possibilities that may impact the above analysis :

- ▶ Paternoster is currently seeking quotations from market participants for a longevity swap contract. This will remove material longevity risk from the Paternoster balance sheet and replace it with counterparty credit risk and operational risk. These risks can be mitigated with appropriate collateralisation.
- ▶ New business may be written into Rothesay. However, I do not believe that this is a material issue. Even if new business is written on a basis which creates some valuation strain, it would be perfectly possible for management to seek to vary the Paternoster permissions and to write new business into Paternoster, in a scenario where a transfer does not take place.

- ▶ Management are currently considering restructuring some portion of Paternoster's TRS - i.e. entering into a further TRS with a third party and unwinding some portion of the existing TRS. This will change the Valuation Rate of Interest and could, if the duration were shorter than the term of the liabilities, introduce some element of reinvestment risk.

5.3 Position for Pillar 2

I have reviewed the pro forma Pillar 2 (ICA) position of both businesses before and after the transfer (as if the transfer had become effective on 31 December 2010). 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, the combined entity free asset ratio is adequate and does not materially impact on the security of the Paternoster policyholders.

5.4 Capital policy for the combined business

At the current time, the Pillar 1 requirement is the more onerous capital requirement for both companies. Both Paternoster and Rothesay are currently holding significant surplus assets in excess of the more onerous requirement.

While the level of these surpluses may fluctuate in the normal course of business, it is the intention of both Boards to ensure that sufficient capital is maintained within the companies, with a capital policy committing that the capital resource requirement is covered at a ratio of 150% for Pillar 1 and that the companies can withstand adverse scenarios measured at the 99.8% confidence level over one year on a Pillar 2 (ICA) basis. (The regulatory requirement is set at a 99.5% confidence level over one year). It is intended that this position will continue following the Part VII transfer of Paternoster to Rothesay.

By 2014, it is expected that the new solvency requirements prescribed within Solvency II will come into effect. While the details of this regime are yet to be finalised, it is the expectation of the Rothesay Board that a corresponding level of capital will be held such that policyholders remain protected against equally adverse scenarios.

It is my understanding that this capital policy will remain under review by the Rothesay Board after the transfer to ensure that it remains appropriate. Any changes to this policy will be approved by the Rothesay Board after appropriate consultation with the FSA.

5.5 Position for Solvency II

I have been informed by management that the relative free asset position of both Paternoster and Rothesay on a Solvency II basis, as evidenced by QIS5 analysis, anticipated future regulation and anticipated internal models, is broadly consistent. There are three issues with this, which need to be taken into account:

- ▶ Firstly, significant parts of the Solvency II regime are still changing, so it is not clear if this view will still be true once regulation is finalised. However, due to the similarities of the companies, it is unlikely that there would be changes that would materially impact one and not the other.
- ▶ In particular, depending on EU / EIOPA views on 'matching premium' / transitional provisions for illiquidity premiums, Rothesay may or may not proceed with their application for an

internal model and may revert to standard factors. However, there is no reason to believe that the relative strength of the two companies is significantly different using internal models than using standard factors.

- ▶ Finally, the revised QIS 5 position for Paternoster on the pro forma basis is based on an internal approximation. Based on this approximation, there are adequate surplus assets to cover the Solvency II capital requirements.

5.6 Excluded policies

The Scheme makes provision for 'Excluded Policies' and 'Residual Assets' which are not able to be transferred on the effective date of the transfer. In practice, it is not expected that there will be any Excluded Policies. Similarly, it is understood that there are unlikely to be any significant assets that are likely to cause difficulties in transfer that would give rise to Residual Assets.

6. Impact of Scheme on original Paternoster policyholders

6.1 Financial strength / security

As set out in Section 5 of this report, Rothesay will continue to meet its capital resources requirements at the transfer date by a relatively comfortable margin on both the Pillar 1 and Pillar 2 (ICA) bases.

The merged excess asset ratios will have increased from the immediate pre-Scheme level, with the excess assets comfortably in excess of the minimum buffer which I would recommend to the Board. Thus, there is no material detriment to the security of policyholders caused by the implementation of the Scheme.

At a high level, there is relatively little change in the security of benefits of ex-Paternoster policyholders if the Scheme were to be approved. This is because the business of Rothesay is very similar to that of Paternoster, containing insurance (longevity) risks and investment guarantees which, since the execution of the total return swap in Paternoster following the acquisition by Goldman Sachs, are being managed in the same way as the equivalent risks in Rothesay. I understand that there are no other economically significant options or discretions within the in-force contracts of Rothesay that would change this view.

I am not aware of any current investigation which has brought to light any significant residual unrecognised liabilities, such as potential mis-selling liabilities.

6.2 Exercise of discretion

I am not aware of any intention to change any areas of discretion currently available in respect of current Paternoster policyholders.

The Actuarial Function Head for Rothesay has provided me with a note of his interpretation of TCF for current Rothesay policyholders. There is nothing in this note that I would consider causes a required change to the existing areas of discretion for Paternoster.

6.3 Administration quality

I am not aware of any significant administrative changes that will affect the combined Rothesay policyholders as a result of the Scheme.

6.4 Summary

Overall, in my opinion, the proposed Scheme setting out the transfer of business will have limited impact on policyholder benefits, security or administrative arrangements for Paternoster policyholders. I believe the communication arrangements are appropriate.

Thus, I do not consider that the FSA Principles to treat customers fairly or to manage conflicts of interest fairly are likely to be breached as a result of the Scheme.

7. Reliances and limitations

7.1 Reliances

This report has been prepared for the Board of Paternoster. Except with our prior written consent, this report must not be reproduced or distributed, in whole or in part, outside your organisation (which, for the avoidance of doubt, includes all member companies of the Goldman Sachs Group).

We do, however, consent to the release of this report to:

- ▶ the advisers appointed in respect of the Scheme by Paternoster and Rothesay;
- ▶ the FSA;
- ▶ the independent expert, Mr O J Gillespie, who has been appointed, with the approval of the FSA, to report on the Scheme; and
- ▶ the Court for the purposes of the Scheme, and being dealt with in a manner consistent with the applicable rules and procedures of the Court.

However, this is provided that:

- ▶ the report is disclosed in its entirety since individual sections, if considered in isolation, may be misconstrued;
- ▶ it is recognised that this report has not been prepared for the advisers appointed in respect of the Scheme by Paternoster and Rothesay, the FSA, the independent expert or the Court and therefore may not address their particular concerns;

In reviewing the Scheme and its effect on the existing policyholders of Paternoster we have relied on the accuracy and completeness of information provided by Paternoster and their advisors.

7.2 Limitations

This paper specifically excludes:

- ▶ areas covered by the above reliances, and
- ▶ the implications of the Scheme for the policyholders of Rothesay
- ▶ the accuracy of the approximate calculation of the Solvency II capital requirement for Paternoster on the pro forma basis


8. Compliance with TAS requirements

Following the Morris review of the actuarial profession, published in March 2005, HM Treasury asked the Financial Reporting Council (FRC) to take on responsibility for setting technical actuarial standards. The FRC created an operating body, the Board for Actuarial Standards, to fulfill that role.

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.

C.5.5 of TAS R requires an analysis of risks and uncertainties. However, a detailed analysis of risk is contained within the firms' ICA reports and is not repeated in this report. Where relevant, some description is given of the risks most relevant to the business arising from the Scheme and the potential impacts on policyholders, which is the main focus of this report.

In addition to complying with TAS R, we can confirm that there have been no material departures from any of the TASs in performing this work.



Gordon Wood,

Fellow of the Institute and Faculty of Actuaries

Head of Actuarial Function, Paternoster UK Limited

14th July 2011