

Rothsay Life Limited

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

Updated report by the Actuarial Function Holder  
of Rothsay Life Limited

18 November 2011

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## Section 1: Purpose and Scope

- 1.1 The purpose of this report is to update the previous report I produced in my capacity as Actuarial Function Holder for Rothesay Life Limited on 6 July 2011. Since the previous report was produced, updated financial information has become available as at 30 September 2011. This report also comments on business and other changes since the previous report and considers whether this updated information has any impact on the conclusions reached in the previous report.
- 1.2 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 implications of the proposed Scheme on the existing policyholders of Rothesay, including the impact on their benefit expectations, the future security of these benefits and the principles to treat customers fairly and manage conflicts of interest fairly.
- 1.3 This update report has been prepared for the Board of Directors of Rothesay in response to a request for such a report by the Board in my role as Actuarial Function Holder to Rothesay.
- 1.4 A separate update report has been prepared by Gordon Wood in relation to his duties as Actuarial Function Holder to Paternoster. Therefore, I have not explicitly considered the implications of the Scheme for the existing policyholders of Paternoster.
- 1.5 Rothesay has provided me with the relevant updated (unaudited) financial information at 30 September 2011.
- 1.6 As noted in Section 6 of the previous report dated 6 July 2011, the security of the Rothesay policyholder benefits following the transfer is a key consideration. It is only necessary for me to be satisfied that Rothesay remains adequately capitalised following the proposed transfer, and the updated financial information addresses this point.
- 1.7 This updated report has been prepared subject to the same reliances and limitations as set out in sections 1 and 8 of the previous report dated 6 July 2011 and section 5 of this updated report.

## Section 2: Updated financial position as at 30 September 2011

- 2.1 The table below sets out the pro forma Pillar 1 financial position of Rothesay and Paternoster 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
Long term fund	2,927	818	3,745
Mathematical reserves	(2,905)	(710)	(3,616)
Surplus in long term fund	22	107	129
Shareholder net assets	305	55	360
Total free assets	326	162	488
Capital resources requirement	(126)	(46)	(173)
Excess assets	200	116	316
CRR cover	259%	350%	283%

\* the Paternoster pro forma numbers are restated from the actual 31 December 2010 position to reflect the restructuring that took place in early January 2011 when Goldman Sachs had completed the acquisition of Paternoster

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

**Table 2.2 Pillar 1 position at 30 September 2011**

£m	Paternoster	Rothesay	Combined entity post Part VII
Long term fund	3,107	1,022	4,129
Mathematical reserves	(3,037)	(916)	(3,953)
Surplus in long term fund	70	106	176
Shareholder net assets	305	55	360
Total free assets	375	161	536
Capital resources requirement	(131)	(55)	(186)
Excess assets	244	106	350
CRR cover	286%	295%	288%

- 2.3 During the nine month period to 30 September 2011, Rothesay has entered into one new arrangement with a pension scheme covering approximately £150m of mathematical reserves and both Rothesay and Paternoster have entered into new reinsurance transactions on the existing blocks of business (further details mentioned in Section 3).
- 2.4 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 Rothesay and Paternoster are Pillar 1 companies. Given the asset strategy of both businesses (i.e. no significant outright credit risk), this is not unexpected.
- 2.5 On a Pillar 2 basis, I consider that the pro-forma free asset ratio of the combined entity is adequate and does not materially impact the security of the Rothesay policyholders.
- 2.6 Although I have not been provided with detailed calculations of the financial position since 30 September 2011, I have been provided with certain 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 Rothesay and Paternoster by any movement in equity markets, and for a movement of 100 basis points in interest rates the capital cover would remain above 275% for both Rothesay and Paternoster.
- 2.7 Note that numbers in these tables have been presented in millions. Consequently there may be rounding differences included within these tables.

## Section 3: Changes since previous report

### Business changes

- 3.1 This section summarises the financially significant business changes that have taken place within either of Rothesay or Paternoster since my original report was produced. I also comment on potential future transactions that have not yet completed as at the date of this report.

### Longevity swaps

#### RGA

- 3.2 With effect from 1 July 2011, Rothesay entered into a new reinsurance arrangement with RGA to "lock in" the assumed longevity experience on a defined block of business. This arrangement relates to both Rothesay and Paternoster business and covers around £1.1bn of longevity risk. Under this arrangement Rothesay 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.

#### Prudential Financial

- 3.3 During early June 2011, Rothesay entered into a new reinsurance arrangement with Prudential Financial, a U.S. based firm, to "lock in" the assumed longevity experience on a defined block of Rothesay business, covering £100m of longevity risk. Subsequently, in October 2011, a further reinsurance arrangement covering £450m of longevity risk has also been concluded with Prudential Financial. This second arrangement covers both Rothesay and Paternoster business.

### Other asset transactions

- 3.4 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.

### Other business changes

- 3.5 Other than the changes described above, 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.

### Potential transactions

- 3.6 The company has informed me that there are currently a number of potential transactions that are in the process of negotiation and which may or may not be completed. I have been supplied with details of the pro forma financial impact of each of these transactions. The detailed financial position of the two companies (and the pro forma financial position for the combined company) as described in Section 5 of my main report and in Section 2 of this supplementary report will be impacted by these transactions if they are completed.
- 3.7 I understand that these transactions are being contemplated in the company's normal course of business and would be subject to the normal governance procedures (including, for example, pricing and capital requirements set by the Board). Although there is the potential for such transactions to give rise to an initial reduction in excess assets, Rothesay's governance procedures and capital policy are such that, should it be required, additional capital will be provided to support such transactions. I am therefore satisfied that, should such new business be written on terms similar to those that have been indicated to me, the conclusions made in Section 6 of my main report, and in Section 4 of this supplementary report, would remain unchanged if any or all of these transactions are completed.

### Regulatory changes

- 3.8 I set out below the main regulatory changes that I consider may impact the business of Rothesay, including draft proposals published in Consultative Papers, and give my opinion on their likely impact.

### Solvency II regulation

- 3.9 There has been no material change to draft Solvency II regulations which would invalidate my previous and current conclusions.
- 3.10 It should be noted, however, that there still remains uncertainty about certain aspects of Solvency II methodology which may be material to both Rothesay and Paternoster. The final methodology for 'matching premium' is a particularly relevant example of an area where such uncertainty exists. However, as the businesses of both Rothesay and Paternoster, treated either as separate entities or combined, are very similar I consider that this uncertainty does not materially change the position of either of the firms before or after the proposed Part VII transfer.

### FSA regulation

- 3.11 The FSA published a consultative paper GC11/18 in July 2011 with comments due 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.

- 3.12 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. Rothesay does have exposure to intra-group arrangements (as well as to other equivalent arrangements with third parties on an arms-length basis) and only entered into these transactions following discussion with FSA, who did not at the time raise any objections that Rothesay considered to be unresolved. 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.
- 3.13 However, I note that this may become an issue for Rothesay to manage even in the event that the proposed transfer were not to proceed, and this potential situation is not worsened for Rothesay policyholders should the Part VII transfer proceed.

#### *Professional regulation – actuarial standards*

- 3.14 Since my previous report was produced on 6 July 2011, two new Technical Actuarial Standards (TASs) published by the Board for Actuarial Standards (BAS) have (from 1 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 1 October 2011 that are of relevance, being APS L1 (Duties and Responsibilities of Life Assurance Actuaries) and APS L2 (Whistle-blowing).
- 3.15 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 "Reserved Work" category as prescribed by BAS, so this report has been prepared in accordance with these standards.

#### *Other regulation*

- 3.16 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 (ie 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.
- 3.17 Although Rothesay 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 Rothesay/Paternoster entity compared to the business of Rothesay as a separate stand-alone business.

## Section 4: Conclusion

### Technical Actuarial Standards

- 4.1 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 Rothesay at the date of transfer, the future security of these benefits and the principles to treat customers fairly and manage conflicts of interest fairly.
- 4.2 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 recently implemented Insurance TAS and the Transformations TAS.

### Changes to conclusion since previous report

- 4.3 I can confirm that I have no reason to change the conclusions reached in my previous report of 6 July 2011.

### Summary of conclusions

- 4.4 In the light of the considerations set out in this report and my previous report of 6 July 2011, I continue to conclude that:
- The security of Rothesay's policyholders is not likely to be adversely affected by the proposed transfer
  - The reasonable benefit expectations of Rothesay'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 Rothesay'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.

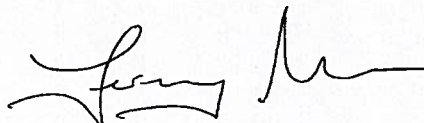
## Section 5: Reliances and limitations

### Reliances

- 5.1 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 me, both in written and in oral form, by Rothesay and Paternoster and their advisers.
- 5.2 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 6 July 2011
  - Unaudited financial statements of Rothesay and Paternoster as at 30 September 2011, and
  - Information relating to the commercial transactions of Rothesay and Paternoster during the 2011 calendar year up until the date of this report.

### Limitations

- 5.3 This report has been prepared on an agreed basis to meet the specific purposes of Rothesay and must not be relied upon for any other purpose. The same limitations apply to this report as applied in my previous report of 6 July 2011 and this report should be read in conjunction with that report.



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18 November 2011

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