MILLIMAN REPORT

The proposed Part VII transfer of non-profit annuity business from The Prudential Assurance Company Limited to Rothesay Life Plc

The Report of the Independent Expert

13 July 2021

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Milliman

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1. Introduction

BACKGROUND

1.1 In 2018 The Prudential Assurance Company Limited ("**PAC**") and Rothesay Life Plc ("**Rothesay**") (collectively "**the Companies**") applied to the High Court of Justice of England and Wales ("**the Court**") for sanction of an insurance business transfer scheme ("**the Scheme**") pursuant to Part VII of the Financial Services and Markets Act 2000 ("**FSMA**") to effect the transfer of certain non-profit annuity policies of PAC (the "**Transferring Policies**" or "**Transferring Business**") to Rothesay. The Sanction Hearing took place between 10 and 20 June 2019.

1.2 On 16 August 2019 Mr. Justice Snowden handed down his judgment ("**the Court Judgment**") on the proposed transfer, in which he declined to sanction the Scheme. In this report ("**this Report**") I refer to the process leading up to Mr. Justice Snowden's decision as "**the 2019 Court Process**", with the Court hearings held pursuant to the 2019 Court Process referred to respectively as the "**2019 Directions Hearing**"[1] and the "**2019 Sanction Hearing**"[2]. Mr. Justice Snowden granted PAC and Rothesay leave to appeal ("**the Appeal**") against his decision, and on 27 September 2019 PAC and Rothesay lodged an appeal against the Court's decision. The main hearing for the Appeal took place between 27 and 29 October 2020.

1.3 On 2 December 2020 the Court of Appeal handed down its judgment ("**the Appeal Judgment**") in which it upheld the Appeal and ordered that the application for the sanction of the Scheme should be remitted to the Court for consideration. The consequent process to be followed by the Court (the "**2021 Court Process**") in its consideration of the Scheme will take a similar form to the 2019 Court Process, i.e. the process that would be followed if a new application for the sanction of an insurance business transfer scheme had been made. That is, a Directions Hearing will be held, followed in due course by a Sanction Hearing.

1.4 The Directions Hearing for the 2021 Court Process (the "**2021 Directions Hearing**") will take place on 23 July 2021. The corresponding Sanction Hearing (the "**2021 Sanction Hearing**") is currently scheduled to take place on 8 November 2021. If the Scheme is sanctioned it is expected to become effective from 15 December 2021; in this Report I refer to the date on which the Scheme becomes effective as the "**Transfer Date**".

1.5 When an application is made to the Court for an order to sanction the transfer of insurance business from one insurer to another, Paragraph 109 of Part VII of FSMA requires the application to be accompanied by a report on the terms of the scheme by a person nominated or approved by the PRA, referred to as the "Independent Expert". PAC and Rothesay appointed me as the Independent Expert for the Scheme, and my appointment was approved by the Prudential Regulation Authority ("**PRA**"), having consulted with the Financial Conduct Authority ("**FCA**"), on 21 June 2018. The Companies have reviewed my continued independence in relation to the Independent Expert role for the 2021 Court Process[3] and sought the non-objection of the PRA and the FCA for me to continue to discharge the Independent Expert role. The PRA, having consulted with the FCA, confirmed on 1 April 2021 that it did not object to my continuing to discharge the role of Independent Expert for the Scheme for the 2021 Court Process.

MY 2019 REPORTS

1.6 In discharging my role as Independent Expert during the 2019 Court Process, I submitted two reports to the Court, namely:

- A report entitled "*The Part VII transfer of non-profit annuity business from The Prudential Assurance Company Limited to Rothesay Life Plc – The report of the Independent Expert*", dated 21 January 2019 (my "**2019 Main Report**"); and

[1] A Directions Hearing is an initial Court hearing at which the companies' plans for notifying policyholders are considered.
[2] A Sanction Hearing is a Court hearing at which the Court considers whether it is appropriate to sanction a Part VII scheme.
[3] My statement of independence is provided in Appendix 1.

- A report entitled "*The Part VII transfer of non-profit annuity business from The Prudential Assurance Company Limited to Rothesay Life Plc – Supplementary Report of the Independent Expert*", dated 17 May 2019 (my "**2019 Supplementary Report**").

1.7 A summary of my 2019 Main Report (the "**2019 Summary Report**") was included in the mailing pack sent to holders of Transferring Policies ("**Transferring Policyholders**") by PAC prior to the 2019 Sanction Hearing.

1.8 In addition to my 2019 Main Report, the 2019 Summary Report and my 2019 Supplementary Report, I wrote four letters to the Boards of Directors of PAC and Rothesay during May and June 2019, including two letters during the course of the 2019 Sanction Hearing:

- The first letter, dated 30 May 2019, issued a correction to the definition of "Guernsey Policies" in my 2019 Supplementary Report.
- The second letter, dated 7 June 2019, confirmed that the conclusions in my 2019 Supplementary Report remained valid in light of the additional objections to the Scheme received from policyholders after the date of finalisation of my 2019 Supplementary Report.
- The third and fourth letters, dated 11 June 2019 and 19 June 2019 respectively, were sent during the course of the 2019 Sanction Hearing. The purpose of these letters was to expand upon, and clarify, some matters covered by my 2019 Main Report and my 2019 Supplementary Report on which discussion took place during the Sanction Hearing. These letters were made available to the Court to assist in its deliberations.

1.9 In this Report, I refer collectively to my 2019 Main Report, the 2019 Summary Report and my 2019 Supplementary Report as the "**2019 Reports**".

1.10 I did not submit any additional reports or letters to the Court of Appeal as part of the Appeal process.

1.11 In my 2019 Main Report I concluded, based on information available at the time, that the implementation of the Scheme would not have a material adverse effect on:

- The security of benefits of the policyholders of PAC and Rothesay, including Transferring Policyholders;
- The reasonable benefit expectations of the policyholders of PAC and Rothesay, including the Transferring Policyholders; or
- The service standards and governance applicable to the PAC and Rothesay policies, including the transferring policies.

I was also satisfied that the Scheme was equitable to all classes and generations of PAC and Rothesay policyholders.

1.12 In my 2019 Supplementary Report I confirmed that the conclusions of my 2019 Main Report remained valid.

THIS REPORT

1.13 The Court process now being followed will consider the existing application of the Companies to sanction the transfer, and is similar to the process that would be followed upon a new application to sanction a Part VII scheme. Accordingly, this Report is constituted as a standalone document that describes and considers all relevant areas of the Scheme in full, and does not rely on the 2019 Reports to provide a complete picture. In drafting this Report I have assumed that readers are not familiar with my 2019 Reports, nor with the details of the various Court and Court of Appeal processes that have so far taken place.

1.14 I have produced a summary of this Report (my "**2021 Summary Report**") that will be sent to Transferring Policyholders by PAC as part of the mailing pack relating to the 2021 Court Process.

1.15 I will prepare a supplementary report (my "**2021 Supplementary Report**"), to be finalised as close as is practicable to the 2021 Sanction Hearing, in which I will update my conclusions on the Scheme in light of financial conditions and any other developments at that time.

1.16 In relation to the scope of this Report, it is important to note that:

- I am only required to comment on the effects of the implementation of the Scheme on policyholders who enter into contracts with PAC and Rothesay prior to the Transfer Date of the Scheme.
- I have not restricted my assessment of the Scheme to consideration of potentially adverse effects.
- I have limited my assessment to the proposals put forward by PAC and Rothesay, and have not considered alternative arrangements or proposals, although Section 11 includes a description of the effects of the non-sanction of the Scheme.
- As far as I am aware, there are no matters within the scope of my role as Independent Expert that I have not taken into account in undertaking my assessment of the Scheme, and in preparing this Report, which nonetheless should be drawn to the attention of policyholders or of the Court in its consideration of the terms of the Scheme.
- I have received all the information I have requested from PAC and Rothesay for the purpose of preparing this Report.

1.17 Transferring Policies which were issued to residents of the Bailiwick of Guernsey (the "**Guernsey Policies**") will transfer pursuant to a Guernsey Scheme of transfer (the "**Guernsey Scheme**"). In addition, Transferring Policies which were issued as part of the business carried on by PAC in or from within Jersey (the "**Jersey Policies**") will transfer pursuant to a Jersey Scheme of transfer (the "**Jersey Scheme**"). The Guernsey and Jersey Schemes will be put before the Royal Court of Guernsey and the Royal Court of Jersey respectively, and I have been provided with copies of the Guernsey Scheme and the Jersey Scheme. This Report and its conclusions apply equally to Guernsey Policies and Jersey Policies as they do to the other long-term insurance business of PAC and Rothesay. This Report, together with my 2021 Supplementary Report, may be presented to the Royal Court of Guernsey and the Royal Court of Jersey in respect of the Guernsey Scheme and Jersey Scheme respectively to satisfy the requirement in each case for a report by an independent actuary on the terms of the scheme.

1.18 The Guernsey Scheme and Jersey Scheme are expected to be put before the relevant courts in late November 2021, with the implementation of the Guernsey Scheme and Jersey Scheme expected to be on the same date as the implementation of the UK Scheme.

1.19 This Report includes some technical terminology relating to UK insurance regulations, insurance products and certain other areas. Section 4 of this Report contains an overview of key aspects of regulations applying to UK life insurers and a description of the insurance product types affected by the Scheme, including a description of the types of policies which are Transferring Policies. Section 4 therefore includes a number of items of terminology that may be useful to readers of this Report. A glossary of terms used in this Report is set out in Appendix 5.

QUALIFICATIONS AND DISCLOSURES

1.20 I am a Fellow of the Institute and Faculty of Actuaries, having qualified in 1982.

1.21 I am a partner of Milliman LLP ("**Milliman**") and I am based in its UK Life Insurance and Financial Services practice. I have fulfilled the role of Independent Expert for over 20 insurance business transfers that have been approved by the Court as listed in Appendix 2, including 5 transfers of non-profit annuity business. I have also acted as Chief Actuary (or equivalent) and as With-Profits Actuary for a number of UK insurers.

1.22 I confirm that I do not have any direct or indirect interest in PAC, Rothesay or other related firms that could compromise my independence.

1.23 My fees for discharging the role of Independent Expert for the Scheme are being shared equally between PAC and Rothesay from their respective shareholder resources.

1.24 A certificate of compliance with Part 35 of the Civil Procedure Rules is attached as Appendix 4. I confirm that I have understood my duty to the Court, the Royal Court of Guernsey and the Royal Court of Jersey.

THE PARTIES FOR WHOM THE REPORT HAS BEEN PREPARED

1.25 This Report, and any extract or summary thereof has been prepared for the use of the Court, the Royal Court of Guernsey and the Royal Court of Jersey, but may also be of interest to the bodies or persons listed below:

- Policyholders of PAC and Rothesay;
- The Directors and senior management of PAC;
- The Directors and senior management of Rothesay;
- The FCA and the PRA, and any other governmental department or agency having responsibility for the regulation of insurance companies in the UK;
- The Guernsey Financial Services Commission;
- The Jersey Financial Services Commission; and
- The professional advisers of any of the above.

1.26 In accordance with the legal requirements under FSMA, copies of my report may be made available to the policyholders of PAC and Rothesay and to other interested parties.

LIMITATIONS

1.27 In preparing this Report, I have had access to certain documentary evidence provided by PAC and Rothesay, and I have had access to, and discussions with, senior management of PAC and Rothesay. My conclusions depend on the substantial accuracy of this information without independent verification. The principal documents which I have reviewed in respect of PAC and Rothesay are listed in Appendix 3. I have considered, and am satisfied with, the reasonableness of this information based upon my own experience of the UK life insurance industry and on the level of review and validation carried out on this information including, in the case of published financial information, external audit.

1.28 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 my 2021 Summary Report for inclusion in the relevant policyholder packs/letters (and, where relevant, distribution to any persons requesting a copy of it); other than this, no summary of my Report may be made without my express consent.

1.29 This Report has been prepared on an agreed basis for the Court 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 to 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.

1.30 Neither this Report nor the 2021 Summary Report provides financial or other advice to individual policyholders.

REGULATORY AND PROFESSIONAL GUIDANCE

1.31 This Report has been prepared under the terms of the guidance ("**Regulatory Guidance**") set out in the PRA's Policy Statement[4] entitled "The Prudential Regulation Authority's approach to insurance business transfers" (the "**PRA Policy Statement**"), in Chapter 18 of the Supervision Manual ("**SUP 18**") contained in the FCA Handbook[5] and in FG18/4[6] "The FCA's approach to the review of Part VII insurance business transfers" (the "**FCA Guidance**"). As the PRA Policy Statement and FG18/4 include requirements specifically in relation to scheme reports, I have included a checklist against these requirements in Appendix 6 of this Report. The PRA, in consultation with the FCA, has also approved the form of this Report.

1.32 This Report has also been prepared having regard to Technical Actuarial Standard ("**TAS**") 100 (Principles for Technical Actuarial Work) and TAS 200 (Insurance), issued by the Financial Reporting Council. In my opinion, my report complies with these standards. In complying with these requirements, I note that several of the key documents listed in Appendix 3 have been prepared or reviewed by individuals who were subject to professional standards in undertaking their work, including, where appropriate, TAS requirements.

1.33 Actuarial Profession Standard ("**APS**") X2, issued by the Institute and Faculty of Actuaries, requires members to consider whether their work requires an independent peer review. In my view this Report does require independent peer review, and such peer review is also required by Milliman's internal quality assurance standards for reports of this nature. This peer review has been carried out by a senior actuary in Milliman LLP who has not been part of my team working on this assignment.

THE STRUCTURE OF THIS REPORT

1.34 Section 2 of this report provides an executive summary of the proposals and of my considerations and conclusions.

1.35 Section 3 of this report provides some information on the matters to be considered by the Independent Expert and Section 4 gives some background information on the current regulatory regime in the UK and on the UK life insurance market, including a description of the non-profit annuity product types relevant to this report.

1.36 Sections 5 and 6 of this report provide some background to PAC and Rothesay respectively, and Section 7 explains the purpose of the Scheme and summarises the key aspects of the Scheme, as well as the background to the Scheme and the related court processes undertaken so far.

1.37 The effects of the implementation of the Scheme on the Transferring Policies, the non-transferring policies of PAC and the policies of Rothesay, and on the holders of these policies, are covered in Sections 8, 9 and 10 respectively. Sections 11 and 12 outline a number of other considerations, Section 13 contains my views on correspondence received so far by the Companies from policyholders, and Section 14 contains my conclusions on the impact of implementing the Scheme.

1.38 The appendices contain my Statement of Independence, a list of my previous assignments as Independent Expert, a schedule of data relied upon in forming my conclusions, my Certificate of Compliance, a glossary of terms used throughout this report and details of how this report complies with the PRA Policy Statement and FG18/4.

[4] https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-approach-to-insurance-business-transfers

[5] https://www.handbook.fca.org.uk/handbook

[6] https://www.fca.org.uk/publications/finalised-guidance/fg18-04-review-part-vii-insurance-business-transfers

2. Executive Summary

2.1 This section provides a summary of the proposed transfer, and a summary of my conclusions. Details and background to the information in this section, as well as definitions of some of the terms used in this section, are contained in the main body of this Report.

SUMMARY OF PROPOSED SCHEME

2.2 On 14 March 2018, Rothesay entered into an agreement with PAC to acquire a portfolio of PAC's non-profit annuity business. In connection with the agreement, the annuities making up the portfolio were reinsured to Rothesay from PAC, with an intention by both companies to go on to formalise the transfer of economic risk through an insurance business transfer under Part VII of FSMA.

2.3 The Companies applied to the Court in 2019 for the sanction of the transfer. The Court declined to sanction the transfer, resulting in the Companies lodging the Appeal against that decision. The Appeal was successful and the Companies have therefore resubmitted their application to the Court for the sanction of the transfer.

2.4 The business reinsured to Rothesay is composed of a combination of retail annuities in payment and bulk annuities (both in payment and in deferment), comprising approximately £12.2 billion of Solvency II best estimate liabilities as at 31 December 2020. The Companies agreed to exclude all but 10 of the deferred annuities (of which only 6 remain in-force) that are within the scope of the reinsured business from the scope of the transfer, in addition to certain annuities in payment, meaning that approximately £1.4 billion of the reinsured liabilities will be excluded from the scope of the transfer.

2.5 Some of the business reinsured to Rothesay is subject to existing longevity reinsurance arrangements and, under the Scheme, Rothesay will replace PAC as the cedant under these reinsurance arrangements.

2.6 All of the business being transferred is either within PAC's Shareholder-Backed Business or reinsured from the PAC WPSF to the PAC Shareholder-Backed Business.

2.7 PAC and Rothesay have agreed a Transitional Services Agreement under which, upon the sanction of the Scheme, PAC will continue to provide administration services (delivered by TCS/Diligenta on its behalf) to Rothesay in respect of the transferring policies for a period of approximately 6 to 12 months after the Transfer Date. During that period, Rothesay will arrange the transfer of the administration arrangements for the Transferring Business to another administrator of its choice.

2.8 Further details of the proposed Scheme are given in Section 7 of this report.

IMPACT OF THE PROPOSED TRANSFER ON TRANSFERRING POLICIES

2.9 I have considered the impact of the implementation of the Scheme on:

- the security of benefits of the transferring policies; and
- the reasonable expectations of the transferring policyholders.

Security of benefits of the transferring policies

2.10 While the benefits of the transferring policies are reinsured to Rothesay, PAC remains responsible for paying the benefits of these policies even if Rothesay is unable to meet its obligations under the reinsurance agreement it has with PAC. Following the transfer, Rothesay would assume responsibility for paying the benefits of the Transferring Policies. In assessing the impact of the transfer on the security of benefits, it is therefore relevant to consider the financial resources available in PAC and Rothesay to provide security for the guaranteed benefits of the Transferring Policies, taking into account:

- the financial strength required under the Solvency II regulations[7] for PAC and Rothesay;
- the capital management policies of PAC and Rothesay, including their relative strengths, the required response to a breach and the governance surrounding them;
- the impact of the cessation of the reinsurance agreement between PAC and Rothesay and of the restrictions on assets held in the associated custody accounts;
- the quality of PAC's and Rothesay's Own Funds; and
- the change in the profile of risks to which the Transferring Policies will be exposed as a result of the transfer;

2.11 I have considered each of these areas in the main body of this report, and in summary:

- For the purposes of the financial information in this report, which uses a reporting date of 31 December 2020, PAC determines its Solvency Capital Requirement using an internal model, whereas Rothesay uses a combination of a partial internal model and the Solvency II Standard Formula, plus a capital add-on agreed with the PRA.
- As at 31 December 2020, PAC's shareholder risk appetite framework (PAC's internal terminology for its capital management policy) and Rothesay's capital management policy target a broadly comparable level of protection against the risk of regulatory insolvency, after taking account of likely management actions available in the event of a deterioration in the solvency position of the companies.
- Both firms have an adequate range of actions at their disposal to mitigate a scenario in which their solvency position starts to deteriorate.
- The solvency coverage ratio of the PAC Shareholder-Backed Business at 31 December 2020 was 171%, compared to the projected solvency coverage ratio of Rothesay at 31 December 2020 had the transfer taken place at that date of 203%. Both companies' solvency ratios are in excess of the target range set out in their respective capital management policies.
- The cessation of the reinsurance agreement between PAC and Rothesay and the associated restrictions on assets held in the custody accounts will not have a material adverse effect on the security of benefits for the Transferring Policies.
- The change in risk profile to which the transferring policies will be exposed as a result of the implementation of the Scheme will not have a material effect on the security of benefits of the Transferring Policies.

2.12 Taking all of the above into account, I am satisfied that the implementation of the Scheme will not have a material adverse impact on the security of benefits under the Transferring Policies.

Reasonable expectations of transferring policyholders

2.13 The Transferring Policies are almost all non-profit in-payment annuities providing regular payments that are contractually guaranteed. Policyholders' reasonable expectations in respect of their policies are that:

- The administration, management, and governance of the policies are in line with regulatory requirements and the contractual terms under the policies;
- The standards of service received are not materially worse than those they currently receive; and

[7] As described in Section 4, the UK is no longer subject to EU insurance regulations after Brexit. However, with the exception of some minor technical amendments, the UK regulatory regime for insurance and reinsurance companies currently remains unchanged and is materially aligned with the current Solvency II regime, which was adopted into UK law as part of the UK's exit from the EU in a process known as "on-shoring". This Report bases its analysis on the Solvency II financial position of the Companies assessed under Solvency II as currently on-shored into the UK regulatory regime, and references to Solvency II should be interpreted accordingly.

- Any discretionary benefits are fair and consistent with current practice.

2.14 The only way in which discretion is exercised by PAC in relation to benefits under Transferring Policies is that, in certain limited circumstances, some holders of Transferring Policies are entitled to elect to exchange some or all of their pension income for a lump sum through a process referred to in this report as commutation. In most cases, the amount of lump sum received per £1 p.a. of pension benefit (the "**commutation factor**") is at the discretion of the insurer. I have received an analysis of a representative sample of the prevailing commutation factors used by PAC and Rothesay; these factors reflect the respective views of the Companies on future investment returns, longevity and inflation. While there are inevitably differences between the two sets of factors, the analysis indicates that policyholders' commuted benefits calculated on Rothesay's current factors are not likely to be systematically higher or lower to any material extent than those calculated on PAC's factors.

2.15 For the 6 deferred annuity policies within the scope of the transfer, Rothesay and PAC have agreed an arrangement whereby the commutation terms offered by Rothesay will be enhanced, if necessary, by an amount based on the differential between PAC's and Rothesay's commutation factors; the analysis and determination of this differential has already been agreed by Rothesay and PAC but can be reviewed, and if necessary amended, prior to the transfer. The effect of this agreement is to ensure that the commutation terms offered by Rothesay to those deferred annuitants will be increased to the extent that, as at the date of the commutation analysis, PAC's commutation terms were more favourable than Rothesay's.

2.16 Taking this into account, I am satisfied that the transfer will not have a material adverse impact on reasonable benefit expectations of Transferring Policyholders.

2.17 The administration of the Transferring Policies is not expected to change in the short term following the transfer due to the expected implementation of the Transitional Services Agreement. During the term of the Transitional Services Agreement Rothesay will arrange for the transfer of the administration services applicable to the Transferring Policies to one of its outsourced service providers.

2.18 I have reviewed the target service standards applicable to Rothesay's existing policies and am satisfied that there is no reason to believe that future administration arrangements for the Transferring Policies will result in a material adverse change in service standards experienced by holders of those policies.

2.19 PAC and Rothesay are subject to the same regulatory requirements around the governance of their long-term insurance business, and Rothesay is experienced in the management and governance of non-profit annuity business. I am satisfied that the transfer will not materially adversely affect the standards of governance and management applicable to the transferring policies.

IMPACT OF THE PROPOSED TRANSFER ON NON-TRANSFERRING POLICIES OF PAC

2.20 I have considered the impact of the implementation of the Scheme on:

- the security of benefits of the non-transferring PAC policies; and
- the reasonable expectations of the non-transferring PAC policyholders.

Security of benefits of the non-transferring PAC policies

2.21 The main change brought about by the transfer from the perspective of the non-transferring policies of the PAC Shareholder-Backed Business is the removal of PAC's exposure to the risk of Rothesay being unable to meet its obligations under the reinsurance agreement between PAC and Rothesay in respect of Transferring Policies. However, the net risk to non-transferring policyholders is currently small, due to the presence of a collateral account for the reinsurance agreement with

Rothesay. In addition, PAC holds part of its capital requirement to cover the residual counterparty default risk, the amount held being determined in accordance with its approved internal model.

2.22 Other than from the change in PAC's counterparty default risk exposure described in paragraph 2.21, PAC's risk exposure would be unchanged as a result of the transfer. The transfer will result in PAC's best estimate liability held in respect of the transferring policies, together with the associated value of amounts recoverable from Rothesay under the reinsurance agreement, being eliminated, which is expected to be neutral to PAC's Own Funds. However, certain effects of the Scheme, including the payment to the PAC With-Profits Fund described below in paragraph 2.27, will reduce the Own Funds of the PAC Shareholder-Backed Business by £7 million, based on the position as at 31 December 2020. The component of PAC's capital requirements that corresponds to the counterparty default risk associated with the reinsurance of the transferring policies to Rothesay will also be eliminated. The collateral account that is currently maintained in connection with the reinsurance agreement will continue to be operated for any policies within the scope of the reinsurance agreement but outside the scope of the transfer.

2.23 In aggregate the changes described in paragraph 2.22 are expected, based on financial information at 31 December 2020, to result in an increase to the SCR Coverage Ratio of the PAC Shareholder-Backed Business of 5 percentage points, and an increase to PAC's consolidated SCR Coverage Ratio of 2 percentage points.

2.24 Aside from the reduced level of counterparty default risk that will be brought about by the transfer, I do not expect any material changes to the profile of risks to which the non-transferring policies of PAC are exposed as a result of the transfer.

2.25 I am therefore satisfied that the transfer will not have a material adverse effect on the security of benefits of the non-transferring PAC policies.

Reasonable expectations of the non-transferring PAC policyholders

2.26 There will be no change to the administration, servicing or governance arrangements applicable to the non-transferring PAC policies as a result of the transfer.

2.27 The transfer out of a proportion of the business of the PAC Shareholder-Backed Business will result in an increase in the size of the PAC With-Profits Fund relative to the shareholder-backed funds. As a result, under PAC's expense allocation approach, a greater proportion of PAC's fixed costs (including annuity administration expenses) will be allocated to the PAC With-Profits Fund, specifically to the PAC WPSF. It has been agreed that the PAC NPSF will make an initial payment, currently expected to be £24 million, to the PAC WPSF after the transfer to compensate it for the increased cost allocation that it will receive as a result of the transfer. A subsequent review will determine whether further compensation is needed to ensure that the PAC WPSF is not materially worse off as a result of this consequence of the transfer.

2.28 The PAC With-Profits Actuary has confirmed that he is comfortable with this approach, and that he does not believe that the increase in costs allocated to the PAC With-Profits Fund will have a material adverse impact on policyholders, given the agreed action referred to in paragraph 2.27. The PAC With-Profits Committee has also indicated it is supportive of the approach.

2.29 I concur with the analysis of the PAC With-Profits Actuary, and I am satisfied that this will not have a material impact on the benefit expectations of the policyholders of the PAC WPSF.

2.30 Taking the above into account, I am satisfied that the transfer will not have a material adverse impact on the reasonable expectations of the non-transferring PAC policyholders.

IMPACT OF THE PROPOSED TRANSFER ON EXISTING POLICIES OF ROTHESAY

2.31 I have considered the impact of the implementation of the Scheme on:

- the security of benefits of the existing policies of Rothesay; and
- the reasonable expectations of the holders of existing policies of Rothesay.

Security of benefits of the existing policies of Rothesay

2.32 As the business to be transferred into Rothesay under the Scheme is already reinsured to Rothesay, the proposed transfer will have no impact on Rothesay's financial position.

2.33 Although inward reinsurance business typically would rank below direct policies in terms of priority over assets in the event of insolvency, the reinsurance agreement has been structured to ensure that PAC has recourse to the assets secured in the collateral accounts in the event of Rothesay's insolvency.

2.34 As the business to be transferred into Rothesay under the Scheme is already reinsured to Rothesay, most of the risks associated with the Transferring Business are already being borne by Rothesay. Additionally, regardless of whether the transfer goes ahead, the Companies have agreed that Rothesay will take over some residual liabilities for mis-selling claims in respect of the Transferring Policies which may be brought in future.

2.35 Taking all of this into account, I am satisfied that the transfer will not have a material adverse impact on the security of benefits of existing policies of Rothesay.

Reasonable expectations of the holders of existing policies of Rothesay

2.36 The transfer will not alter the terms and conditions of existing Rothesay policies, nor will there be any change to servicing, administration or governance arrangements for existing Rothesay policies as a result of the transfer.

2.37 The transfer will have no impact on the amounts payable to existing Rothesay policyholders who elect to commute some or all of their pension benefit to a lump sum.

2.38 I am therefore satisfied that the transfer will not have a material impact on the reasonable expectations of holders of existing policies of Rothesay.

CONSIDERATION OF THE REINSURANCE AGREEMENT

2.39 In this report I have considered:

- whether my conclusions in relation to the transfer would have been different if I had considered the combined impact of the reinsurance agreement between PAC and Rothesay and the transfer; and
- the implications of the non-sanction of the Scheme.

Combined impact of the reinsurance agreement and the transfer

2.40 The reinsurance agreement between PAC and Rothesay resulted in an improvement in the financial position of PAC and, in isolation, a deterioration of the financial position of Rothesay. However, at the time of the reinsurance agreement, Rothesay raised sufficient additional capital from its shareholders for the net impact of the reinsurance agreement and the capital-raising exercise on Rothesay's financial position to be very small.

2.41 The improvement in PAC's financial position and the broadly neutral impact on Rothesay's position means that I would not have altered my conclusions in respect of non-transferring PAC policies or existing Rothesay policies had I included the effect of the reinsurance agreement between PAC and Rothesay in my considerations.

2.42 For the Transferring Policies, the combination of the reinsurance agreement and the transfer would have led to a larger increase in available financial strength than that expected to arise from the transfer alone. Accordingly, I would not have altered my conclusions in respect of Transferring Policies had I included the effect of the reinsurance agreement between PAC and Rothesay in my considerations.

The implications of the non-sanction of the Scheme

2.43 If the transfer is not sanctioned, the reinsurance agreement between PAC and Rothesay is expected to remain in place. While PAC would have the option to terminate the reinsurance agreement if the transfer is not sanctioned, it is not expected that PAC would wish to exercise this option.

2.44 As the reinsurance agreement led to an improvement in PAC's financial position, and had no material impact on the financial position of Rothesay, I am satisfied that policyholders would not be materially adversely affected by the reinsurance agreement remaining in place if the Scheme were not sanctioned.

2.45 The termination of the reinsurance agreement would be likely to be disadvantageous to PAC's financial position and could have a material adverse impact on the security of benefits of PAC policyholders. For this reason, I consider it highly unlikely that PAC would choose to effect such a termination in the event that the Scheme is not sanctioned. Rothesay would only be in a position to terminate the reinsurance agreement if there was a default by PAC which triggered a termination right; this is discussed in more detail in Section 11.

OTHER CONSIDERATIONS ARISING FROM THE SCHEME

2.46 In this report I have considered:

- The impact of COVID-19 on the Scheme;
- The approach to communication with policyholders;
- The costs of the Scheme;
- External reinsurance where PAC or Rothesay is the cedant;
- Asset counterparties;
- Tax;
- Other creditors
- Future corporate transactions;
- The Financial Services Compensation Scheme and Financial Ombudsman Service;
- The effect of the proposed Scheme on previous schemes; and
- The future operation of the Scheme.

The impact of COVID-19

2.47 The COVID-19 pandemic has not affected the ability of the Companies to continue their business as normal, and the Companies believe that there is no reason why the pandemic should affect their ability to bring forward their application to sanction the Scheme in the normal way.

2.48 I have considered this in Section 12, but in summary I am satisfied that, under current conditions, it is appropriate for the Companies to pursue the implementation of the Scheme, although the continuing uncertainty surrounding the future course of the pandemic means that this position should be kept under review; I will update my conclusion on this in my 2021 Supplementary Report.

The approach to communication with policyholders

2.49 As part of the 2019 Court Process, PAC and Rothesay mailed their policyholders communications in relation to the Transfer, subject to certain waivers granted by the Court, complying with the requirements in this respect of the applicable regulations under FSMA.

2.50 For the 2021 Court Process, PAC and Rothesay intend to publish legal notices in a number of national newspapers in the UK, and will make information available on their respective websites, as well as PAC's financial adviser website.

2.51 PAC proposes to send a pack to all Transferring Policyholders, including relevant trustees or employers holding policies on behalf of pension scheme beneficiaries. This pack will comprise a covering letter and an information booklet containing:

- A summary of the Scheme;
- A summary of the report by the Independent Expert;
- A questions and answers section; and
- A copy of the legal notice of the transfer.

2.52 PAC received a waiver in 2019 from notifying its non-transferring policyholders, as well as from notifying some categories of Transferring Policyholders, and PAC intends to follow the same approach in respect of the 2021 Court Process. PAC has made available a web-based tool and phone line for existing annuity policyholders to use to confirm whether they are in the scope of the proposed transfer.

2.53 I am satisfied that PAC's proposed approach of not notifying non-transferring PAC policyholders is reasonable.

2.54 Rothesay does not intend to mail its existing policyholders again in respect of the transfer, except to write to:

- the 10 policyholders who submitted an objection to the transfer in 2019, and to provide further information where specifically requested on an individual basis or to respond to a query or objection; and
- trustees of the pension schemes that have entered into buy-in transactions with Rothesay since the letter Rothesay sent to its policyholders at the time of the 2019 Court Process[8].

2.55 Rothesay will also issue a welcome letter to Transferring Policyholders if the Scheme is approved by the Court.

2.56 Given that the economic risks of the Transferring Policies have already been assumed by Rothesay, and the proposed transfer will have no impact on Rothesay's financial position, I consider this to be a reasonable approach.

2.57 I have reviewed draft versions of the PAC policyholder pack and am content that it provides a satisfactory level of information on the proposed transfer and a clear explanation of the consequences for Transferring Policyholders.

[8] Trustees of pension schemes which entered into buy-in transactions with Rothesay that were subsequently converted into buyouts will not be written to by Rothesay.

Other considerations

2.58 My analysis of the other areas listed in paragraph 2.46 is contained in section 12 of this report. I am satisfied that none of these areas alters my conclusions in relation to the proposed Scheme.

OVERALL CONCLUSIONS

2.59 I am satisfied that the implementation of the Scheme will not have a material adverse effect on:

- The security of benefits of the policyholders of PAC and Rothesay, including the Transferring Policyholders; or
- The reasonable benefit expectations of the policyholders of PAC and Rothesay, including the Transferring Policyholders; or
- The standards of service, management and governance applicable to the PAC and Rothesay policies, including the Transferring Policies.

2.60 I am satisfied that the Scheme is equitable to all classes and generations of PAC and Rothesay policyholders.

3. General Considerations of the Independent Expert

THE ROLE OF THE INDEPENDENT EXPERT

3.1 As described in Section 1 of this report, the Scheme concerns two life insurance companies: PAC and Rothesay. I need to consider the terms of the Scheme generally and how the different groups of policyholders of PAC and Rothesay are likely to be affected by the implementation of the Scheme. I am required by the Regulatory Guidance to consider:

- The effect of the implementation of the Scheme on the security of the policyholders' contractual rights, including the likelihood and potential effects of the insolvency of the insurer;
- The effect of the implementation of the Scheme on matters such as investment management, new business strategy, administration, expense levels and valuation bases insofar as they may affect:
  - the security of policyholders' contractual rights;
  - levels of service provided to policyholders; or
  - the reasonable expectations of policyholders; and
- The cost and tax effects of the Scheme, insofar as they may affect the security of policyholders' contractual rights or their reasonable expectations.

3.2 I am only required to comment on the effects of the implementation of the Scheme on policyholders who enter into contracts with PAC and Rothesay prior to the Transfer Date of the Scheme.

3.3 In this report I have not restricted my assessment of the Scheme to consideration of potential adverse effects.

3.4 In this report I have restricted my assessment to the proposals put forward by PAC and Rothesay, and have not considered alternative arrangements or proposals.

3.5 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 of the policyholder's risk exposure will be the characteristics of the company in which the policy is held, for example:

- The amount and quality of capital resources available, other calls on those capital resources and any capital support currently available to the company;
- The internal capital management policy of the company;
- The investment strategy of the company;
- The mix of business of the company;
- The company's business strategy, e.g. whether the company is open or closed to new business, its acquisitions strategy; and
- Other factors, such as operational risks faced by the company, reinsurance arrangements of the company, the company's governance framework and its tax position.

THE DEFINITION OF 'POLICYHOLDER'

3.6 In this report I use the term 'policyholder' to include all of the following, whether or not they are policyholders as a matter of law:

- The holders of policies, including individual or joint life annuities (in payment and deferred), in Rothesay or PAC.

- The trustees of pension schemes where an insurance contract has been bought to cover part of the liabilities of that scheme (commonly known as a "**buy-in**") or to mitigate the longevity risk[9] associated with the scheme's liabilities (commonly known as a "**longevity swap**"), with Rothesay, PAC or a predecessor company[10].
- The underlying members of these pension schemes that have entered into a buy-in or longevity swap with Rothesay, PAC or a predecessor company.
- The dependants of other policyholders who have contingent benefits.

SECURITY OF POLICYHOLDER BENEFITS

3.7 As part of my role as Independent Expert for the Scheme, I need to consider the security of policyholders' contractual rights; that is, the effect of the implementation of the Scheme on the likelihood that policyholders will receive their guaranteed benefits when these are due.

3.8 In considering and commenting upon policyholder security, I shall primarily consider policyholders' guaranteed benefits. The regulations require insurance companies to hold a minimum amount of capital in addition to the assets backing a market-consistent estimate of their liabilities to policyholders.

3.9 The amount by which the assets available to support the insurance business exceed the liabilities provides security for the guaranteed benefits.

3.10 When commenting on the Companies' financial strength in this Report, I have primarily focused on "**SCR Coverage Ratio**" as a measure of financial strength. The SCR Coverage Ratio is the ratio of the company's Own Funds to its Solvency Capital Requirement, i.e. the number of times its available capital can cover its required capital. A definition and description of Own Funds and the Solvency Capital Requirement is given in Section 4.

3.11 The SCR Coverage Ratio is a commonly used measure of financial strength, but insurers' financial positions are complex and therefore a single ratio cannot provide complete information about financial strength, despite the improvement in comparability of insurers' financial positions that the Solvency II regulations have brought about. In particular, SCR Coverage Ratio is a "point in time" measure and only gives information about the ability of the insurer to meet its capital requirements at that point in time[11]. For example, it does not make any allowance for the future capital needs the insurer may have to support any new business written in the future. Additionally, the SCR Coverage Ratio does not provide full information on how resilient the SCR coverage is to adverse scenarios, and two insurers with the same SCR Coverage Ratio may therefore have a different level of solvency resilience.

3.12 For these reasons I have also commented in this Report on scenario analysis carried out by PAC and Rothesay that tests the continued resilience of their respective solvency positions to future plans around new business and potential adverse scenarios, which will be of particular relevance to my assessment of the impact of the Scheme on the Transferring Policyholders. In addition, unlike the SCR Coverage Ratio, capital management policies are commonly formulated to give information about resilience to potential future adverse scenarios, and therefore it is important that I consider the relative strength of the Companies' capital management policies in parallel with their respective SCR Coverage Ratios.

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[9] The risk of financial loss resulting from scheme members living longer, on average, than expected

[10] The term "predecessor company" refers to an insurer which issued buyout or buy-in policies that were subsequently transferred into PAC or Rothesay by means of a Part VII transfer.

[11] For the avoidance of doubt, the reference to a "point in time" measure does not mean that the SCR Coverage Ratio only reflects the ability of an insurer to meet those obligations expected to arise over the short term. Rather, it means that it is based on the insurer's in-force business and market conditions at a particular point in time (in the case of information in this Report, that point in time is 31 December 2020), but included in the SCR Coverage Ratio is an assessment of the extent to which the insurer is able to meet its liabilities in full over their entire duration, both under baseline assumptions (based on conditions at 31 December 2020) and under the stress scenarios that underpin the calculation of the SCR.

POLICYHOLDERS' REASONABLE EXPECTATIONS

3.13 I also need to consider the proposals in the context of the regulatory obligation on both companies to treat their customers fairly and, in particular, the effect of the implementation of the Scheme on policyholders' reasonable expectations.

3.14 This involves considering the effect of the implementation of the Scheme on any areas where discretion is involved on behalf of the relevant insurance company, for example in determining the charges applied to a policy and the benefits granted to a policyholder when commuting pension benefits for a lump sum, as well as consideration of the effect of the implementation of the Scheme on the management, service and governance standards of the company in question.

THE CONCLUSIONS OF THE INDEPENDENT EXPERT

3.15 My assessment of the impact of the Scheme on the various groups of affected policies is ultimately a matter of actuarial judgement regarding the likelihood and impact of possible future events. Given the inherent uncertainty of the outcome of such future events and that the effects may differ across different groups of policies, it is not possible to be certain about their effect on the policies.

3.16 In order to acknowledge this inherent uncertainty, the conclusions of the Independent Expert in respect of Part VII transfers of long-term insurance business are usually framed using a materiality threshold. If the potential impact under consideration is very unlikely to happen and does not have a large impact, or is likely to happen but has a small impact, then it is not considered to have a material effect on the policies.

3.17 My primary focus as Independent Expert is on identifying any consequences of the transfer that may be adverse to one or more groups of policyholders or other stakeholders, in other words, effects that may be contrary to their interests. This, along with the materiality framework outlined in paragraph 3.16, results in many of my conclusions being framed with a view to identifying whether or not particular aspects of the transfer will, in my view, result in a 'material adverse effect' on a particular group.

3.18 The Appeal Judgment provided some guidance on the approach to be taken by the Court in considering Part VII schemes of this type. In summary:

- The Court's primary concern is whether the proposed scheme will have a material adverse effect on policyholders, employees or other stakeholders.
- An adverse effect is only material if it is
  - a possibility that cannot sensibly be ignored having regards to the nature and gravity of the feared harm in the particular case;
  - a consequence of the proposed scheme, and
  - material in the sense that there is the prospect of real or significant, as opposed to fanciful or insignificant, risk to the position of the stakeholder concerned.
- Where policy benefits are contractually guaranteed, the main issue is whether the proposed scheme will have a material adverse effect on the receipt by policyholders of those benefits, or on the standards of service provided.
- The likelihood of non-contractual parental support being available to the transferor and transferee in the future is not a relevant factor, nor is it appropriate to place weight on resources in excess of the amounts which the insurers are obliged to retain.

- Factors such as the age, venerability and reputation of the transferor and transferee are not relevant to the Court's consideration.

3.19 I have taken account of this guidance in my consideration of the Scheme. In my analysis I have considered the possible availability of non-contractual parental support, and resources in excess of amounts required to be retained by the Companies' capital management policies, as this may be considered to be of some interest to other readers of this Report. However, the validity of my conclusions is not dependent on the availability of such support or resources.

THE 2021 SUPPLEMENTARY REPORT

3.20 As noted in paragraph 1.15, I will prepare my 2021 Supplementary Report prior to the 2021 Sanction Hearing, to provide an update for the Court on my conclusions in the light of any significant events subsequent to the date of the finalisation of this Report.

3.21 The 2021 Supplementary Report will be made available on the PAC and Rothesay websites.

RELIANCE ON LEGAL ADVICE

3.22 There are some aspects of the Scheme that are legal matters which fall outside my expertise. For these areas, I have considered whether it is appropriate to take independent legal advice and I have decided that it is appropriate for me to rely on the advice provided to PAC and Rothesay by Allen & Overy LLP and Latham & Watkins LLP respectively.

3.23 The areas where I have relied on advice from the Companies' legal advisers are:

- Various factual matters in relation to the features of the proposed Scheme and the legal process to be followed to seek the sanction of the Scheme; and
- The review of any impact of the Scheme on previous court schemes (see paragraphs 12.77 and 12.78).

3.24 My reasons for being content to rely on this advice are:

- The relevant legal matters do not appear to be contentious; and
- The fair treatment of policyholders is not dependent on the legal advice.

3.25 I am therefore satisfied that it is appropriate for me to rely on the conclusions of Allen & Overy LLP and Latham & Watkins LLP in forming my view on the Scheme.

4. The UK Life Insurance Market and Regulatory Environment

INTRODUCTION

4.1 The regulatory regime to which UK insurers are subject, and the applicable solvency requirements, are relevant to my considerations as Independent Expert and are summarised in this section.

THE UK REGULATORS

4.2 Responsibility for the regulation of UK insurance companies is split between the PRA and the FCA.

4.3 The PRA is a part of the Bank of England and carries out the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms.

4.4 The PRA has statutory objectives to promote the safety and soundness of the insurers that it regulates, and to contribute to ensuring that policyholders are appropriately protected. More generally, these statutory objectives can be advanced by seeking to ensure that regulated insurers have resilience against failure and that disruption to the stability of the UK financial system from regulated insurers is minimised.

4.5 The FCA regulates the conduct of all financial services firms in relation to consumer protection, industry stability and the promotion of healthy competition between providers, as well as being the prudential supervisor for financial services firms that are not supervised by the PRA.

THE UK REGULATORY REGIME FOR INSURANCE COMPANIES

Introduction

4.6 Prior to the UK's exit from the European Union ("**EU**") on 31 January 2020, and during the Brexit transition period between 31 January 2020 and 31 December 2020, UK insurance and reinsurance companies were subject to the regulatory solvency framework applicable to the European Economic Area ("**EEA**"), known as "**Solvency II**", which came into effect on 1 January 2016[12]. Solvency II imposes capital requirements on insurers and reinsurers that reflect the specific risks faced by each insurer and reinsurer and aims to achieve consistency across the EEA. All but the smallest EEA insurance companies are required to adhere to a set of risk-based capital requirements, and to disclose their solvency position in a public document.

4.7 On 17 December 2020, the European Insurance and Occupational Pensions Authority ("**EIOPA**")[13] published its Opinion on the 2020 Review of Solvency II, which set out its advice to the European Commission in relation to its review of certain areas of the Solvency II framework. This Opinion identifies a number of areas of the Solvency II framework where EIOPA believes changes should be made, and therefore it is likely that the Solvency II regulations will change as a result of this Opinion, with changes expected to come into effect around 2024.

4.8 With effect from 1 January 2021 responsibility for the regulatory solvency framework applicable to UK insurance and reinsurance companies has reverted to the UK authorities. However, with the exception of some minor technical amendments, the UK regulatory regime for insurance and reinsurance companies currently remains unchanged and is aligned almost entirely with the current Solvency II regime, which was adopted into UK law as part of the UK's exit from the EU in a process known as "on-shoring". On 23 July 2020 the UK Government announced that it would review certain features of Solvency II, and a call for evidence in relation to this review was published by HM Treasury on 19 October 2020. This call for evidence emphasises potential areas for reform of Solvency II. On 16 June 2021, the PRA announced that it would be undertaking a Quantitative Impact Study ("**QIS**") to support the review of Solvency II. The details of this QIS have not been made public as at the date of this Report. The announcement of this QIS, along with

[12] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (Text with EEA relevance)

[13] EIOPA is an EU supervisory body responsible for advising EU institutions on the regulatory framework for, and supervision of, insurance and occupational pensions sectors in Europe.

other public statements made by senior employees of the PRA, mean that it is likely that certain aspects of the UK's regulatory regime for insurers and reinsurers will change in the future, potentially moving the UK regulatory regime out of alignment with Solvency II but, except as noted in paragraph 4.9 below, it is not possible at this point to identify the nature of any such changes. It is also not known to what extent (if at all) the UK regulatory regime will follow any changes to the Solvency II regime that come about as a consequence of the EIOPA Opinion described in paragraph 4.7.

4.9 Notwithstanding that the UK regulatory regime is materially aligned with the current Solvency II regime as at the date of this Report, the PRA announced on 3 June 2021[14] that the approach it uses to derive the risk-free interest rate curve (see paragraph 4.13) that is required to be used by UK insurers to determine their regulatory solvency position for GBP-denominated liabilities will change from 31 July 2021. This change reflects a change in the underlying financial instruments used to calibrate the risk-free interest rate curve; the current curve is derived from prices of interest rate swaps linked to the London Interbank Offered Rate ("**LIBOR**"), whereas from 31 July 2021 swaps linked to the Sterling Overnight Index Average ("**SONIA**") rate will be used, reflecting the planned discontinuation of LIBOR at 31 December 2021. There will also be a consequential change in the adjustment made by the PRA to swap rates to reflect credit risk in the risk-free interest rate curve. By contrast, EIOPA is still consulting on how and when it will reflect the discontinuation of LIBOR (and equivalent interest rates for other currencies) in its published risk-free interest rate curves, and therefore the risk-free interest rate curves required to be used for GBP-denominated liabilities will no longer align between UK regulations and the Solvency II regulations from 31 July 2021. I have commented on the impact of this change as it relates to the Scheme in Section 12.

4.10 Given that it would be speculative to comment on other potential future changes to the UK regulatory regime for insurance and reinsurance companies, I have in this sub-section described the Solvency II regime as currently on-shored into the UK regulatory regime (and references to Solvency II in this Report should be interpreted accordingly), noting that material divergence of the UK regime from the Solvency II regime over time is possible for the reasons described in paragraphs 4.7 and 4.8.

4.11 In this section references to "insurers" can generally be interpreted as being equally applicable to both insurance and reinsurance companies.

General structure of Solvency II and UK insurance supervision

4.12 I have described in more detail later in this section the Solvency II regime and wider aspects of regulation and capital management for UK insurers but, in summary, the principal areas providing for the financial safety and soundness of UK insurers are:

- The **Solvency II Pillar 1 requirements,** which require the regular determination of the insurer's financial position in accordance with the Solvency II regulations. This financial position is reported quarterly to the PRA and ensures that the insurer's available capital resources are regularly determined and compared against the level required by Solvency II. The amounts required to be held under Solvency II comprise:
    - **Technical Provisions**, which represent the insurer's liabilities in relation to its insurance obligations, and are intended to represent the amount of assets that would need to be transferred to a third party in an arm's length transaction for that third party to take over the insurer's insurance obligations;
    - **Other liabilities,** which represent liabilities of the insurer not directly related to its insurance obligations; and
    - The **Solvency Capital Requirement** ("**SCR**"), which represents the minimum required level of assets in excess of Technical Provisions and other liabilities ("**Own Funds**") that insurers are required to maintain. The derivation of the SCR is intended to ensure that the insurer remains able

[14] "PS12/21 | CP1/21 – Solvency II: Deep, liquid and transparent assessments, and GBP transition to SONIA" - https://www.bankofengland.co.uk/prudential-regulation/publication/2021/january/solvency-ii-deep-liquid-and-transparent-assessments-gbp-transition-to-sonia

to meet its Technical Provisions over a one year period with a probability of at least 99.5%; in other words that it would remain able to transfer its obligations to a third party following a 1-in-200 year adverse event.

Solvency II also provides for the calculation of a Minimum Capital Requirement ("**MCR**"), which is normally smaller than the SCR[15] and which, if breached, would trigger intensive regulatory intervention.

- **Insurers' capital management policies**, which are specific to individual insurers and set out the way in which the insurer's board of directors has determined that it should manage its capital resources, and specify the minimum level of capital resources in excess of the SCR that the insurer will commit to holding.

- The **Solvency II Pillar 2 requirements**, which require insurers to put in place effective risk management and governance frameworks allowing them to measure, monitor, manage and report on their risks on a continuous basis. The Pillar 2 requirements also require insurers to conduct an Own Risk and Solvency Assessment ("**ORSA**") which, inter alia, considers the solvency needs of the insurer (taking into account its risk profile) and assesses the insurer's ability to continuously meet its Technical Provisions and capital requirements.

- **The regulatory role of the PRA:** Under FSMA (as amended), the PRA has two primary objectives:

    - A general objective to promote the **safety and soundness** of all of the firms it regulates; and

    - An objective specific to its regulation of insurers to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.

  The PRA also has a secondary objective to act, so far as is reasonably possible, in a way that facilitates effective competition in the markets for services provided by the firms it regulates when they carry on regulated activities[16].

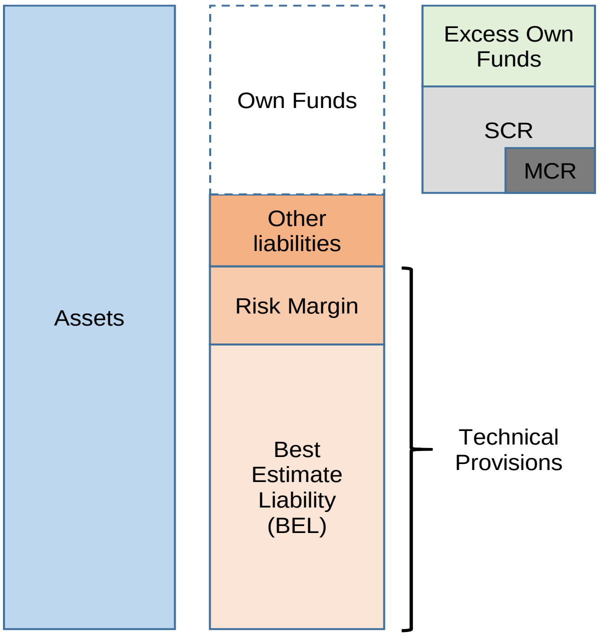
  In practice, the PRA undertakes close supervision of the operations of UK insurers and their compliance with regulatory requirements, including the Solvency II regulations as currently on-shored into the UK regulatory regime. The PRA also imposes specific requirements and responsibilities on senior individuals employed by firms it regulates via the Senior Managers and Certification Regime. In addition to this supervision, the PRA has the power to take any necessary measures to ensure that insurers comply with their regulatory obligations. In the remainder of this sub-section I describe in more detail the features of Solvency II and UK insurance supervision that are relevant to the Scheme.

[15] The MCR is subject to an absolute floor of €3.7 million, meaning that it may be larger than the SCR for very small insurers.

[16] The PRA's approach to insurance supervision is set out here: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/insurance-approach-2018.pdf

The Pillar 1 requirements

FIGURE 4.1 – COMPONENTS OF THE SOLVENCY II PILLAR 1 FINANCIAL POSITION



4.13 Under Solvency II, an insurer's liabilities relating to its insurance obligations are known as its Technical Provisions, which are required to be determined using market-consistent principles. However, as insurance liabilities are not generally traded in listed markets, the market-consistent requirement is typically met by deriving the Technical Provisions as the sum of the insurer's Best Estimate Liability ("**BEL**") and its Risk Margin, the Risk Margin being an adjustment designed to bring the Technical Provisions up to the amount that another insurance or reinsurance undertaking would be expected to require in order to take over and meet the insurance obligations in an arm's length transaction.

4.14 The BEL is determined by projecting the expected future obligations of the insurer over the lifetime of the contracts using the most up-to-date financial information and using best estimate actuarial assumptions. The BEL is then derived as the present value[17] of these projected cash flows. In the absence of approval to apply the Matching Adjustment or the Volatility Adjustment (see paragraphs 4.28 to 4.34), the discount rates[18] used in the derivation of this present value are based on the swap curve[19] prevailing at the balance sheet date, and are intended to reflect a risk-free rate of return.

4.15 Assets are, broadly speaking, recognised at their market value on the Solvency II Pillar 1 balance sheet. Future recoverables from outward reinsurance arrangements are recognised as an asset on the Solvency II balance sheet, with the value attributed to reinsurance recoverables being derived consistently with the BEL for the liabilities covered by the reinsurance arrangement.

4.16 Under the Solvency II regime, the excess of assets over liabilities, plus any subordinated liabilities, is known as Own Funds. Own Funds can be thought of as the capital available in the company to meet capital requirements.

4.17 Under Solvency II, companies are required to classify their Own Funds into three tiers, which broadly represent differing levels of quality of Own Funds in respect of their ability to absorb losses. The Own Funds of the highest quality are classified as Tier 1. In order to be classified as Tier 1, Own Funds must exhibit both of the following:

[17] The present value of a set of future cash flows refers to the amount that would need to be invested now, under a given assumption about future rates of interest, in order to exactly meet the cash flows.

[18] "Discount rates" refers to the future rates of interest assumed in the derivation of the present value.

[19] "Swap curve" refers to the fixed rates available on interest rate swaps of different tenors as at the balance sheet date. An interest rate swap is a financial instrument under which two parties swap cash flows based on an agreed notional amount; one party pays a fixed proportion of the notional amount in each period (this proportion being known as the "fixed rate") and the other pays a proportion of the notional in each period equal to the prevailing short-term interest rate at that time.

- **Permanent availability**, i.e. the item is available, or can be called up on demand, to fully absorb losses on a going concern basis, as well as in the case of winding up.
- **Subordination,** i.e. in the case of winding up, the total amount of the item is available to absorb losses and the repayment of the item is refused to its holder until all other obligations, including insurance and reinsurance obligations towards policyholders and beneficiaries of insurance and reinsurance contracts, have been met.

4.18 Own Funds that are classified as Tier 2 or Tier 3 are of a lower quality, with less ability to fully absorb losses.

4.19 For Own Funds not classified as Tier 1, certain quantitative restrictions exist on the extent to which such Own Funds can be used to meet Solvency II capital requirements. The amount of Own Funds after the application of such restrictions is known as the insurer's Eligible Own Funds.

4.20 Insurers are required to maintain sufficient Eligible Own Funds to meet both the SCR and the MCR.

4.21 As stated in paragraph 4.12, the SCR under Solvency II is intended to be the amount required to ensure that the insurer's assets continue to exceed its Technical Provisions over a one year time frame with a probability of 99.5%. The SCR is derived based on all of the assets and liabilities of the insurer, and makes allowance, subject to certain criteria being met, for the presence of any risk-mitigating instruments such as reinsurance arrangements and derivatives-based hedges.

4.22 It should be noted that, while the SCR is calibrated by reference to the impact of adverse scenarios that manifest themselves over a one year period, the SCR is not intended to relate merely to the insurer's ability to meet its outgoings during that year. Instead it relates to the ability of the insurer to meet its outgoings during the year and to meet its Technical Provisions in full at the end of the year, and Technical Provisions take account of all of the insurer's future obligations in respect of its in-force business, however far into the future they arise. Moreover, while the SCR is intended to be calibrated based on adverse scenarios over a one year period, in practice many of the stress tests prescribed as part of the Solvency II Standard Formula (see paragraph 4.24) are expressed as permanent, rather than one year, adverse scenarios. For example, under the Standard Formula annuity providers are required to establish capital against the risk that mortality rates reduce **permanently** by 20% relative to expected mortality rates.

4.23 The MCR, which is lower than the SCR other than for very small insurance companies, defines the point of intensive regulatory intervention. The MCR calculation is simpler, more formulaic and less risk-sensitive than the SCR calculation.

4.24 In deriving the SCR, some firms use the "**Standard Formula**", as prescribed by EIOPA (with UK insurers still required to follow the EIOPA rules under the current UK regulatory framework). However, Solvency II also permits firms to use their own internal models, or alternatively a combination of a partial internal model and the Standard Formula, to derive the SCR. These internal models and partial internal models are subject to approval by the relevant regulator; in the UK this is the PRA.

4.25 The Standard Formula SCR is derived by evaluating standalone capital requirements for a set of prescribed risks to which most insurers are exposed. The capital requirement relating to each risk is derived by applying a prescribed stress to the insurer's assets and liabilities, with the adverse impact of this stress on the net assets representing the capital requirement for that risk. Each of these capital requirements is intended to represent a "1-in-200" level of severity (i.e. equivalent to the 99.5% confidence level described in paragraph 4.21) for the risk to which it relates. The overall SCR is then derived by aggregating the standalone capital requirements using a set of formulae that are intended to reflect the level of diversification[20] between the individual risks.

4.26 The methodology used in internal models to derive the SCR varies from insurer to insurer, but in essence the internal model ensures that all material quantifiable risks to which the insurer is exposed (and against which capital is an

[20] Diversification refers to a situation where an insurer is exposed to a number of unrelated/unconnected risks, which means that they are less likely to be materially affected by the manifestation of any single risk. By contrast, an insurer with a small number of risks is more likely to be materially affected by the manifestation of a single risk, all other things being equal.

appropriate mitigant) are reflected in its SCR, and allows the insurer to calibrate the capital requirement for those risks to its individual circumstances.

4.27 Any UK firms wishing to use an internal model, or to apply any of the adjustments to the Technical Provisions discussed in paragraphs 4.28 to 4.40, must formally apply to the PRA for approval to do so.

The Matching Adjustment

4.28 In calculating the BEL for certain types of business, typically non-profit in-payment annuity liabilities, the Solvency II rules permit firms to apply to their regulator to make use of the "**Matching Adjustment**". The Matching Adjustment is an increase to the discount rate used in the calculation of the BEL, which results in a smaller BEL. This, in effect, allows firms to take credit via a smaller BEL for the additional investment return in excess of the risk-free rate of return that they expect to earn from a "hold to maturity" investment strategy for their less liquid and higher yielding assets, which are used to back their most stable and predictable liabilities.

4.29 The size of the Matching Adjustment is, broadly, derived as the excess over the risk-free curve of the weighted average risk-adjusted yield on the assets allocated to back the relevant liabilities as at the balance sheet date. The asset's yield is 'risk-adjusted' by subtracting the "**Fundamental Spread**" from the gross asset yield. The Fundamental Spread is intended to represent the portion of the asset's yield that represents the credit risk on the asset, and therefore the investor should not expect to earn that portion of the asset's yield, even under a "hold to maturity" investment strategy. The Fundamental Spread is prescribed by the PRA and depends principally on the asset's credit rating and term to maturity.

4.30 The remainder of the asset's spread is assumed to represent compensation for the relative lack of liquidity of the assets. The rationale behind the Matching Adjustment is that annuity providers have sufficiently predictable liabilities that they should not need to sell the assets backing them, and instead can hold them to maturity, which means they will earn the portion of the yield representing the asset's relative illiquidity and can therefore take credit for it in their BEL discount rate.

4.31 Firms with approval to apply the Matching Adjustment are subject to various restrictions around the types of asset that are permitted to back the relevant liabilities, the circumstances in which the assets may be traded, and the extent to which mismatching of asset and liability cash flows is permitted.

4.32 Liabilities subject to the Matching Adjustment, and assets used to back those liabilities, are required to be separately identified from other parts of the insurer's asset and liability portfolio. The assets and liabilities that relate to business subject to the Matching Adjustment are often referred to as a "**Matching Adjustment Portfolio**".

The Volatility Adjustment

4.33 For certain liabilities that are not eligible for use of the Matching Adjustment, the Solvency II rules permit firms to apply to the PRA to make use of the "**Volatility Adjustment**". Similar to the Matching Adjustment, the Volatility Adjustment is an increase to the discount rate used in the calculation of the BEL for liabilities that are eligible for the Volatility Adjustment and that are not already subject to the Matching Adjustment. However, the Volatility Adjustment is usually significantly smaller than the Matching Adjustment. The Volatility Adjustment is a mechanism that aims to prevent forced sales of assets in the event of extreme bond spread movements.

4.34 The Volatility Adjustment is based on the spreads on a representative portfolio of assets for each relevant currency, and "risk-free" discount curves which include the Volatility Adjustment are published by the PRA.

The transitional measures

4.35 Insurers are also permitted to apply to the PRA to make use of transitional measures. Transitional measures allow firms to phase in the balance sheet impact of moving from the pre-Solvency II regulatory regime (commonly referred to as "**Solvency I**") to the Solvency II regulatory regime. There are two transitional measures available to insurers:

- The Transitional Measure on Technical Provisions ("**TMTP**") allows firms to phase in the increase in Technical Provisions that resulted from the change in regulations from the Solvency I regulatory regime to Solvency II over a sixteen year period. In the UK, the TMTP is based on the difference between the Solvency II Technical Provisions and the Solvency I Pillar II liabilities[21] as at 1 January 2016.
- The Transitional Measure on the Risk-Free Interest Rate allows firms to phase in any reduction in the discount rate used to calculate their liabilities under Solvency II relative to the previous solvency regime over a sixteen year period.

4.36 The TMTP is widely used by UK insurers. The Transitional Measure on the Risk-Free Interest Rate is not widely used by UK insurers, and in particular is not used by either party to the Scheme.

4.37 For a given firm, the TMTP is calculated as at the implementation date of Solvency II, i.e. 1 January 2016, as the excess, if positive, of the firm's Technical Provisions under Solvency II over the firm's insurance liabilities under the previous Solvency I Pillar II regime.

4.38 A further test is then carried out to determine whether deducting the calculated TMTP from the firm's Solvency II Technical Provisions at 31 December 2015 would result in a Financial Resources Requirement ("**FRR**") under Solvency II that is lower than the firm's FRR under the previous Solvency I regime at the same valuation date. The FRR for a given solvency regime is calculated as the firm's total liabilities plus the firm's capital requirement under that regime. If the Solvency II FRR after deduction of the TMTP is lower than the FRR under Solvency I, the calculated TMTP must be reduced to a level that ensures that this is no longer the case.

4.39 The final calculated TMTP is deducted from the firm's Technical Provisions in its Solvency II balance sheet at 1 January 2016. For valuation dates after 1 January 2016, the TMTP that was calculated at 1 January 2016 is reduced linearly to zero over a sixteen year period. Therefore, any business written after 1 January 2016 does not benefit from the TMTP, even if the Technical Provisions for that business exceed those that would have been required under Solvency I Pillar II[22].

4.40 A firm's TMTP is subject to a mandatory recalculation every two years, subject to approval from the PRA. This recalculation reflects changes in economic and other conditions that have taken place since the previous recalculation. Insurers may also apply to the PRA to recalculate their TMTP every six months if they believe that their risk profile has changed materially since the previous recalculation.

Ring-fenced funds

4.41 Solvency II includes the concept of a ring-fenced fund. This refers to any arrangement where an identified set of assets and liabilities are managed as though they were a separate undertaking, meaning that there are restrictions on the extent to which surplus in the ring-fenced fund may be transferred to shareholders or used to cover losses outside the ring-fenced fund.

4.42 In the UK, many firms have set up ring-fenced funds in order to reflect the arrangements applicable to their with-profits funds and to the with-profits and non-profit business within the with-profits funds.

THE GOVERNANCE OF UK LONG-TERM INSURERS

4.43 For most UK long-term insurers the Board of Directors is the firm's governing body, and is ultimately responsible for setting the strategic direction of the firm, overseeing the activities of the firm's day-to-day management and approving the firm's financial statements.

[21] Solvency I Pillar II refers to the Individual Capital Adequacy Standards framework, which was similar in approach to Solvency II but without the requirement for a Risk Margin in the Technical Provisions.

[22] Insurers which, after 1 January 2016, acquire (by way of a Part VII transfer or reinsurance) business that was written prior to 1 January 2016, are still eligible to benefit from the TMTP on the acquired business if it meets the various regulatory criteria in relation to the TMTP.

4.44 Under Solvency II, all insurers are required to establish a number of functions as part of their systems of governance, specifically:

- **Actuarial Function –** the Actuarial Function is responsible for, amongst other things, coordinating the calculation of the Technical Provisions and providing an opinion to the Board of Directors on the firm's underwriting policy and the adequacy of the firm's reinsurance arrangements. The person having responsibility for the Actuarial Function under Solvency II is known in the UK as the Chief Actuary.
- **Risk Management Function** – the Risk Management Function's role is to facilitate the implementation of the insurer's risk management system. The person having responsibility for the Risk Management Function under Solvency II is known in the UK as the Chief Risk Officer.
- **Compliance Function** – the Compliance Function's role is to advise the Board of Directors on compliance with the UK regulatory regime and on other aspects of the legal environment.
- **Internal Audit Function** – the Internal Audit Function's role is to evaluate the effectiveness and adequacy of the insurer's internal control system and of the system of governance. The Internal Audit Function is required to be objective and independent from the operational functions. The person having responsibility for the Internal Audit Function under Solvency II is known in the UK as the Head of Internal Audit.

4.45 In addition to the Solvency II requirements around governance, UK insurers are subject to the Senior Managers and Certification Regime ("**SM&CR**"), operated jointly by the PRA and the FCA. The SM&CR defines a set of senior management functions ("**SMFs**"), which includes:

- Chief Executive Officer;
- Chief Financial Officer;
- Chief Risk Officer;
- Chief Actuary;
- Head of Internal Audit; and
- Head of Key Business Area.

4.46 The individuals responsible for these functions are subject to PRA approval.

4.47 In addition to the roles listed above, insurers with with-profits business must appoint a With-Profits Actuary ("**WPA**") to perform the With-Profits Actuary function. The WPA's responsibilities include advising the firm's management on the key aspects of the discretion to be exercised affecting those classes of the with-profits business of the firm in respect of which they have been appointed. The WPA role is one of the SMFs.

4.48 In relation to each with-profits fund, firms must appoint a With-Profits Committee ("**WPC**") (or a "**with-profits advisory arrangement**" if appropriate given the size, nature and complexity of the fund in question). The WPC's role is to advise and provide recommendations to the firm's governing body on the management of the with-profits business, and to act as a means by which the interests of with-profits policyholders are appropriately considered within a firm's governance structures.

A FIRM'S RISK APPETITE AND INTERNAL CAPITAL MANAGEMENT POLICY

4.49 The Board of Directors of a firm is responsible for the management of the company and for its exposure to risk. The Board will typically set out its appetite for risk in a form which references the probability that the Board is willing to accept of not being able to pay policyholder liabilities as they fall due and/or meet regulatory requirements.

4.50 In order to ensure that day-to-day fluctuations in markets and other experience do not lead to a breach of regulatory capital requirements, insurers usually aim to hold more capital than strictly required to meet the regulatory minimum. The details of the target level of capital buffer are typically set out in the firm's capital management policy.

4.51 The capital management policy of a firm is set by and owned by the Board and describes the amount and quality of capital resources that the Board has determined should be held in the company. Changes to this policy usually require Board approval and appropriate consultation with the PRA.

4.52 The capital management policy is typically framed in terms of the capital requirements set down by the relevant regulations. The regulatory capital requirements typically target a particular probability of remaining solvent over a certain time horizon: for example the Solvency II regulatory regime specifies that the SCR should be such that firm's assets continue to exceed its Technical Provisions over a one year time frame with a probability of 99.5%. By requiring additional capital to be held on top of the regulatory requirements, the capital management policy increases the probability of remaining solvent over a particular timeframe and therefore increases the security of the benefits provided under the policies subject to that policy.

4.53 The level of capital required may also be driven by the desire of the Board to maintain a certain credit rating with external credit rating agencies.

THE PRODUCTS AND LONG-TERM BUSINESS RELEVANT TO THIS REPORT

4.54 The Scheme provides for the transfer of a portfolio of non-profit annuity business written by PAC, consisting of:

- Retail annuities in payment; and
- Bulk annuities in payment[23].

4.55 In the context of this report, an annuity is a policy under which a regular pension is paid to a policyholder until their death. The pension amount may be fixed or may be subject to regular increases. Increases may be based on a fixed annual percentage or linked to changes in an inflation index.

4.56 A retail annuity is an annuity policy purchased by an individual from the proceeds of their pension savings, e.g. the proceeds from defined contribution pension scheme savings.

4.57 A bulk annuity arises when the trustee of a defined benefit pension scheme enters into a buy-in or buyout contract with an insurance company to transfer some or all of its liabilities to the insurer.

4.58 Under a buy-in contract, the pension scheme trustee pays a lump sum to the insurer in return for the insurer insuring a defined subset of the scheme's liabilities. Under the terms of the contract, the insurer reimburses the pension scheme trustee for the pension benefits covered by the buy-in as they fall due. The bulk annuity is therefore an asset of the pension scheme, and ultimate responsibility for paying pension benefits of the scheme members remains with the pension scheme trustee.

4.59 Under a buyout contract, the pension scheme pays a lump sum to the insurer, in return for which the insurer issues individual policies to the scheme members covered by the contract and takes over responsibility from the pension scheme trustee for paying their pension benefits directly to them. The individuals covered by the buyout cease to be members of the pension scheme, and responsibility for paying pension benefits to these individuals transfers to the insurer.

4.60 Under buy-in contracts, the pension scheme trustee is the policyholder of the insurer, whereas under a buyout the individuals receiving the pension benefits are the policyholders. However, as described in paragraph 3.6, in this report I consider members of pension schemes that have entered into a buy-in contract to be policyholders even if they are not policyholders of the relevant insurer in the legal sense.

[23] With the exception of 6 policies that are in deferment.

4.61 Buyouts and buy-ins sometimes cover a mixture of “in-payment” and “deferred” pensions. An in-payment pension refers to the situation where the pension scheme member/policyholder is receiving their pension. A deferred pension refers to the situation where the pension scheme member/policyholder is not yet receiving their pension, but is no longer accruing pension benefits within the pension scheme.

4.62 Buyouts and buy-ins generally do not cover “active” members of the pension scheme, i.e. those members who are still accruing pension benefits.

4.63 Some of these contracts may include additional benefits, such as spouse’s or other dependants’ annuities to be paid on the death of the main policyholder, and a guaranteed return on death of the main policyholder during a specified guarantee period (typically 5 to 10 years).

4.64 For the avoidance of doubt, none of the annuities to be transferred under the Scheme is with-profits, and in particular no profit-sharing or participating features apply to the Transferring Business.

4.65 Rothesay’s existing business comprises non-profit annuity business, as well as longevity swap[24] business issued to defined benefit pension schemes. PAC, additionally, has the following lines of business which are not in scope of the transfer:

- Conventional non-profit life business
- Unit-linked business
- Conventional with-profits (“**CWP**”) business; and
- Accumulating with-profits (“**AWP**”) business.

4.66 Conventional non-profit life business refers to insurance business where the benefits received by policyholders are of defined monetary amounts, for example a life insurance policy that pays a fixed death benefit.

4.67 Unit-linked business is principally a type of investment product where policyholders’ premiums are used to buy units in investment funds. The value of the policyholder’s units is generally updated on a daily basis, such that it moves in line with the performance of the investments in the fund, net of any charges levied on the policy. At maturity or earlier surrender or transfer, policyholders receive the value of their units.

4.68 CWP business typically refers to policies where policyholders’ premiums are fixed and they have a maturity benefit that is guaranteed at the outset in monetary terms or as a conversion to an annuity on guaranteed terms. This benefit can subsequently be increased by bonuses that are awarded at the discretion of the insurer, depending upon the surplus emerging in the insurance fund in which the policies are invested. Once they have been awarded, bonuses are typically guaranteed and insurers are not able to take them away. A final bonus may also be awarded at the time of a claim.

4.69 AWP business typically refers to policies where policyholders’ premiums are used to buy units whose value is then increased through bonuses that are awarded at the discretion of the insurer, again depending on the surplus emerging in the relevant insurance fund. At maturity, policyholders typically receive the value of their units, which again may include a final bonus amount.

4.70 It is typical for insurers to target policyholder pay-outs for both CWP and AWP policies to be relatively close to the policy’s “asset share”, which is a measure of the true value of the policy based on actual investment returns and expenses incurred by the fund, subject to meeting any guaranteed benefits payable under the policy.

Risks associated with non-profit annuity business

4.71 Insurers writing non-profit annuity business are subject to a number of risks to their financial position, some of which I have referred to later in this Report. In this sub-section I have summarised the most material of the financial risks to

[24] Under a longevity swap with a pension scheme, the insurer reimburses the pension scheme for an agreed proportion of its actual pension payments in return for an agreed schedule of cash flows payable by the pension scheme to the insurer. The effect of this transaction is to pass on the scheme’s longevity risk on the relevant portion of its liabilities to the insurer.

which annuity providers are most commonly exposed in relation to their in-force portfolios, noting that different annuity providers have different risk exposures.

4.72 **Longevity risk**: This refers to the risk that annuitants survive for longer than the insurer has assumed, resulting in the annuities being required to be paid over a longer period.

To mitigate this risk, many annuity providers make use of longevity reinsurance, which passes a portion of the longevity risk on their annuity portfolios to a reinsurer. Under Solvency II insurers are required to hold capital against any residual longevity risk after longevity reinsurance has been taken into account.

4.73 **Interest rate risk**: Annuities are very long-duration liabilities, which results in the value of the insurer's BEL being sensitive to the level of risk-free interest rates as at the balance sheet date. The lower the level of interest rates, the lower discount rate used in the BEL calculation, resulting (all else being equal) in a higher BEL, and vice versa. Falls in interest rates also typically increase the size of the insurer's Risk Margin and SCR (and vice versa).

To mitigate this, annuity providers will typically invest in long-duration assets, the market value[25] of which is also sensitive to the level of risk-free interest rates; a reduction in risk-free interest rates will (all else being equal) increase the market value of the assets and vice versa. Therefore, by investing in such assets, the insurer's financial position will be partially immunised against changes in risk-free interest rates as their assets and liabilities will move to offset each other as interest rates change. In addition to investing in long-duration assets, many annuity providers also enter into derivatives positions whose values are sensitive to the level of interest rates, such as interest rate swaps[26] or swaptions[27], as an additional tool to manage their exposure to changes in interest rates.

However, despite this, the insurer's financial position will usually have a residual exposure to changes in interest rates, referred to as "**interest rate risk**", and under Solvency II insurers are required to hold capital against any residual exposure of their Own Funds to changes in interest rates.

4.74 **Default/downgrade risk**: Annuity providers typically invest in fixed interest assets such as bonds or loans to back their annuity liabilities. These assets typically yield fixed cash flows, but are exposed to the risk that the issuer of the asset defaults on its obligations ("**default risk**"), resulting in the proceeds received from the asset being significantly lower than expected. The asset is also exposed to the risk of having its credit rating downgraded ("**downgrade risk**"); such a downgrade could cause the market value of the asset to reduce, which is equivalent to an increase in the asset's gross yield[28]. In relation to assets that are part of a Matching Adjustment Portfolio, an increase in the asset's gross yield (all else being equal) should result in an increase in the asset's contribution to the Matching Adjustment and therefore to a reduction in the insurer's Solvency II BEL to offset the reduction in the asset value; however, a credit downgrade would also result in an increase in the asset's Fundamental Spread (see paragraph 4.29) and therefore any increase in the Matching Adjustment would not be sufficient to offset the whole of the loss in the asset value from the downgrade.

To mitigate default and downgrade risk, insurers would typically ensure that they invest in a high quality, diversified portfolio of assets without undue concentration in individual sectors, geographies or individual issuers. They may also elect to invest in assets that have some form of associated collateral asset(s) or other security, of which the insurer is entitled to take ownership in the event of the issuer's default. Credit derivatives also exist (for example, credit default

[25] The value at which the asset is traded in a liquid market (if applicable), or the value at which the asset may be sold in an arm's length transaction.

[26] An interest rate swap is a transaction under which two parties exchange regular payments based on an agreed notional amount. One party's payments are fixed at outset, based on a fixed rate applied to the notional amount, and the other party's payments are variable, and are based on the notional amount multiplied by the level of market interest rates prevailing at the time of the payment. The value of an interest rate swap is sensitive to the level of market interest rates.

[27] An interest rate swaption is a transaction between two parties under which one of the parties has the unilateral right, but not the obligation, to enter into an interest rate swap with the other party at an agreed future date, with an agreed notional amount and an agreed fixed rate. The value of an interest rate swaption is sensitive to both the level and the volatility of market interest rates.

[28] The gross yield on a fixed interest asset is the discount rate at which the present value of the contractual interest and principal payments equates to the market value of the asset. The gross yield represents the annualised return an investor would earn if they purchased the asset at its current market value and received all contractual cash flows. If the market value of the asset falls, a higher discount rate will be required in order to equate the present value of interest and principal to the market value, and therefore a lower market value is equivalent to a higher gross yield (and vice versa).

swaps) that provide a pay-out in the event of the default of a named counterparty; these can be used to mitigate the risk of default or downgrade.

Insurers are required to hold capital against their residual default and downgrade risk (i.e. net of the impact of any risk mitigants) under Solvency II.

4.75 **Spread risk**: The fixed interest assets typically held by insurers to back annuity liabilities are subject to the risk that their market values reduce for reasons other than default, downgrade or an increase in underlying interest rates ("**spread risk**"). Such a reduction in market value is equivalent to an increase in the asset's gross yield and, since underlying interest rates are assumed not to have increased, it represents an increase in the "spread" of the asset's yield over underlying risk-free interest rates. If the asset is part of a Matching Adjustment Portfolio, and the increase in spread has not arisen because the asset has defaulted or been downgraded, it is likely that a significant proportion of the increase in the spread on the asset will be offset by an increased Matching Adjustment and consequent reduction in the insurer's Solvency II BEL.

The principal mitigant used by annuity providers against spread risk is therefore the offsetting increase in the Matching Adjustment described above. To the extent that the increase in Matching Adjustment does not fully offset the increase in the asset spreads, insurers are required to hold capital against this residual spread risk under Solvency II.

4.76 **Inflation risk**: In addition to the general risk that inflation increases the insurer's own cost base by more than expected, annuity providers typically have inflation-linked annuities within their portfolio. Such annuities can have contractually guaranteed inflationary increases linked to changes in the Retail Prices Index ("**RPI**") or the Consumer Prices Index ("**CPI**"), often subject to caps (upper limits e.g. an annual increase of not more than 5%) and floors (lower limits e.g. an annual increase of not less than 0%) on the level of increase in any given year.

Insurers typically mitigate inflation risk by investing in inflation-linked bonds or enter into inflation-linked derivatives to match their inflation-linked liabilities; such strategies do not always fully eliminate the insurer's exposure to inflation, particularly in situations where there are floors on the level of inflationary increases applied to annuity outgo but the insurer's inflation-linked investments and derivatives do not protect it with a similar guarantee.

Under the Solvency II Standard Formula, insurers are only required to hold capital against their inflation risk under Solvency II to the extent that the inflation risk relates to their own expenses[29]. Annuity providers using internal models generally hold capital against the inflation risk on their annuity liabilities, net of any risk mitigants.

4.77 **Counterparty risk**: Annuity providers' financial positions are exposed to the risk of the failure of key counterparties, in particular reinsurers and derivatives counterparties.

In the case of a reinsurer, if the reinsurer were to fail the insurer may not receive the full value of its liabilities from the reinsurer but would still be required to meet the liabilities covered by the reinsurance; it is also likely that the insurer's Risk Margin and SCR would increase upon a default as the risk-mitigating benefit of the reinsurance falls away.

In the case of derivatives counterparties, the failure of such a counterparty could leave the insurer with a loss where the value of the derivative to the insurer is positive and exceeds the amount recoverable through taking ownership of associated collateral, and could also leave the insurer's financial position exposed to changes in market conditions (against which the derivative in question was providing protection), meaning the insurer may need to hold a higher capital requirement as a result.

Insurers generally mitigate counterparty risk by ensuring that they are exposed to a diversified range of counterparties, often with limits on the level of exposure to individual counterparties or groups of counterparties. Insurers are also required to hold capital against their counterparty risk under Solvency II.

4.78 **Property risk**: While it is not common for insurers to back annuity business with direct investments in residential or commercial property, some annuity providers invest in loans that have residential or commercial property as underlying

[29] Although allowance is made in the BEL for the expected impact of inflation on inflation-linked liabilities.

collateral, for example commercial mortgage loans or lifetime mortgages[30]. This exposes the insurer to the risk of falls in the value of the underlying property.

Insurers generally mitigate exposure to property risk by strict underwriting processes in relation to the quality of the property, low loan-to-value ratios and, where possible, a regionally diversified set of underlying properties.

Under the Solvency II Standard Formula, insurers are not required to hold explicit capital against the property risk related to loans (as opposed to direct investments in property), but this risk is deemed to be addressed by the more general "spread risk"[31] capital requirement within the Standard Formula. By contrast, annuity providers subject to internal models would typically hold explicit capital against risks associated with property values as they relate to such assets.

4.79 **Liquidity risk**: Liquidity risk refers to the risk that an insurer does not have sufficient cash to meet its liabilities as they fall due. Annuity liabilities are generally deemed to be illiquid, i.e. they are relatively predictable in terms of amount and timing compared to other insurance liabilities, without the risk of unexpected large outgoings. Insurers therefore often back significant proportions of their annuity liabilities with illiquid assets as it is not generally necessary for assets to be sold at short notice to meet annuity outgo, provided that assets that are a good match for the liabilities are chosen. However, significant liquidity strains can arise where annuity providers have entered into derivative transactions, as such transactions typically require the insurer to post cash or other liquid assets as collateral at short notice if the value of the derivative moves against the insurer.

Liquidity risk is typically mitigated by ensuring that the insurer has sufficient liquid assets and projected cash income from its investments to meet its outgo as it falls due, even under stressed conditions, or alternatively that the insurer has recourse to guaranteed liquidity facilities in the event of a liquidity strain.

Solvency II does not require capital to be held against liquidity risk as capital is not necessarily an appropriate mitigant for this risk.

THE FINANCIAL INFORMATION IN THIS REPORT

4.80 The PRA has granted approval for:

- PAC to use the Matching Adjustment, the TMTP and an internal model ("**Internal Model**") for Solvency II reporting; and
- Rothesay to use the Matching Adjustment, the TMTP and a combination of a partial internal model ("**PIM**") and the Standard Formula for Solvency II reporting,

and the Solvency II financial information shown in this Report reflects these approvals.

4.81 The financial information shown in this Report is, unless otherwise stated, as at a balance sheet date of 31 December 2020.

4.82 The financial information used in the analysis of the effects of the Scheme is set out in Sections 8 to 10 of this report.

4.83 I have not carried out a full independent review of the Solvency II financial information as at 31 December 2020, but:

- PAC's Solvency II results (excluding the SCR, the TMTP and the Risk Margin) as at 31 December 2020 have been audited by PAC's external auditors (KPMG LLP) and approved by the PAC Board; and

[30] A lifetime mortgage is a fixed rate mortgage offered to over 55s to allow them to release equity from their home. Typically no interest is payable during the customer's lifetime; instead the mortgage amount, including accrued interest, is repaid upon the customer's death or permanent entry into long-term care. Nearly all lifetime mortgages offer a "no negative equity guarantee", which guarantees that the customer does not need to pay back more than the sale value of the underlying residential property, which directly exposes the lender to the risk of a fall in the underlying property value to below the outstanding loan amount at the time the mortgage is repaid.

[31] Under the terminology of the Solvency II Standard Formula, "spread risk" refers to the risk of spread widening as well as the risk of default or downgrade on bonds, loans and other fixed interest investments.

- Rothesay's Solvency II results (excluding the SCR, the TMTP and the Risk Margin) as at 31 December 2020 have been audited by Rothesay's external auditors (PwC LLP) and approved by the Rothesay Board.

4.84 I am satisfied that it is reasonable to rely upon these Solvency II results for the purpose of this report.

4.85 My 2021 Supplementary Report will contain Solvency II financial information as at 30 June 2021 and will provide an update on the effect of the implementation of the Scheme based upon these figures.

5. Background to PAC

BACKGROUND

5.1 PAC is a proprietary company, the ultimate parent of which is M&G plc.

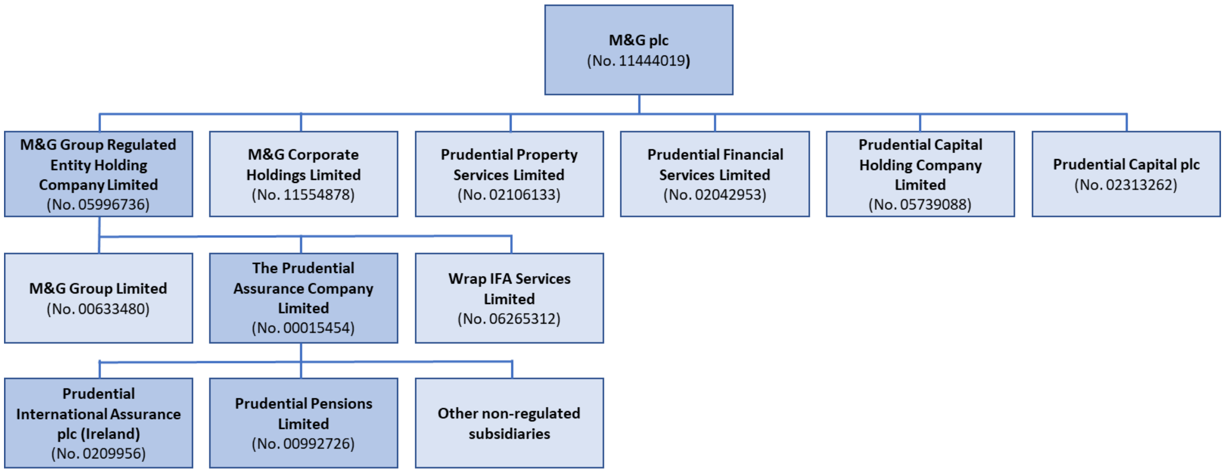
5.2 M&G plc is an international financial services group with operations principally in Europe (predominantly the UK), and is the holding company of the M&G Group[32].

5.3 PAC's principal activity is long-term insurance business, although PAC also has some general insurance business that is no longer sold but in relation to which there remain some contingent liability claims.

5.4 PAC operates as the main insurance company within the M&G Group.

5.5 Figure 5.1 below shows the simplified current structure of the M&G Group, including where PAC sits within the group.

FIGURE 5.1 SIMPLIFIED GROUP STRUCTURE OF M&G GROUP



PAC'S CURRENT FUND STRUCTURE

5.6 As at 31 December 2020, PAC had approximately £205 billion of assets[33].

5.7 PAC has permission to effect and carry out long-term insurance business of Classes I (life and annuity), II (marriage and birth), III (linked long-term), IV (permanent health), VI (capital redemption) and VII (pension fund management) as set out in Part II of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. PAC also has permission to effect and carry out all classes of general (non-life) insurance business.

5.8 PAC currently has two ring-fenced with-profits sub-funds as defined under Solvency II. These are:

- The PAC With-Profits Sub-Fund (the "**PAC WPSF**"); and
- The PAC Defined Charge Participating Sub-Fund (the "**PAC DCPSF**");

These are referred to collectively as the "**PAC With-Profits Fund**".

5.9 Until 1 April 2021, PAC had a third ring-fenced with-profits fund, namely the Scottish Amicable Insurance Fund (the "**SAIF**"). Effective from 1 April 2021 the SAIF was merged into the PAC WPSF, and therefore references to the PAC With-Profits Fund in this Report implicitly include reference to the assets and liabilities that were previously allocated to the SAIF.

5.10 Capital support arrangements exist under which support is provided by the PAC WPSF to the PAC DCPSF in return for charges levied on asset shares of policies invested in the PAC DCPSF. The capital support arrangements between

[32] In this Report I have referred in various places to the "M&G Group". For the avoidance of doubt, this refers to the group of companies shown in Figure 5.1, and not to the legal entity M&G Group Limited.

[33] On a Solvency II basis.

these ring-fenced funds do not affect, nor are they affected by, the Scheme and therefore are not covered in detail in this report.

5.11 The business outside the PAC With-Profits Fund is called the "**PAC Shareholder-Backed Business**", as the capital for such business has been provided by PAC's shareholder. PAC also maintains a presentational division of the PAC Shareholder-Backed Business for reporting and management purposes between the PAC Non-Profit Sub-Fund (the "**PAC NPSF**"), which contains the long-term business of PAC outside of the PAC With-Profits Fund and the assets allocated to that business, and the PAC Shareholder Fund ("**PAC SHF**").

5.12 The PAC Shareholder-Backed Business consists of:

- The PAC shareholder-backed long-term insurance business in the PAC NPSF;
- The PAC shareholder-backed short-term insurance business (the "**PAC general insurance business**") in the PAC SHF; and
- All other assets and liabilities of PAC outside the PAC With-Profits Fund, including the wholly owned insurance subsidiaries of PAC that have been allocated as assets of the PAC SHF:
    - Prudential Holborn Life Limited ("**PHLL**")[34];
    - Prudential Pensions Limited ("**PPL**"); and
    - Prudential International Assurance plc ("**PIA**").

5.13 The table below shows the breakdown of the BEL of the PAC Shareholder-Backed Business at 31 December 2020:

TABLE 5.2 – SPLIT OF BEL OF THE PAC SHAREHOLDER-BACKED BUSINESS AT 31 DECEMBER 2020

Component	BEL (gross of reinsurance)
	£m
PAC SHF (excl. subsidiaries)	-
PAC NPSF	41,739
PIA	8,117
PPL	11,200
Total	**61,056**

Note: The figures in Table 5.2 differ from the BEL underlying the financial position shown in Table 5.4 as they do not eliminate the impact of intragroup reinsurance. For example, some of the business of PPL is reinsured to the PAC NPSF, and therefore the BEL related to this business will appear in both of these lines.

PAC NPSF PRODUCTS

5.14 The business of the PAC NPSF primarily comprises non-profit annuities, unit-linked investment products and lifetime mortgage products. The non-profit annuity liabilities in the PAC NPSF include:

- Annuities originally written by Scottish Amicable Life plc ("**SAL**") that were transferred to PAC on 31 December 2002;
- Annuities written directly in the PAC NPSF; and
- Annuities originally written in Prudential Retirement Income Limited ("**PRIL**") that were transferred to PAC on 1 October 2016.

[34] PHLL no longer undertakes any insurance business and PAC holds only a nominal investment in PHLL.

5.15 The PAC NPSF also includes PAC's defined charge participating business, with the exception of the business that was transferred to PAC from The Equitable Life Assurance Society ("**ELAS**") on 31 December 2007. The investment element of the defined charge participating business is allocated to the PAC DCPSF. The business transferred from ELAS is allocated to the PAC DCPSF, but the PAC NPSF bears all of the expenses of this business in return for the value of a charge levied on ELAS asset shares.

5.16 The table below shows, in summarised form, the insurance product mix of the PAC NPSF by BEL, including the business to be transferred under the Scheme.

TABLE 5.3 – PAC NPSF IN-FORCE BUSINESS AT 31 DECEMBER 2020

Product Type	BEL (gross of reinsurance)
	£m
Annuities	29,440
Unit-linked	12,229
Total	**41,739**

Note: PAC's lifetime mortgage business is not included in this table as it is not an insurance product

PAC WITH-PROFITS FUND PRODUCTS

5.17 The most material product lines of the PAC With-Profits Fund are a large volume of traditional with-profits business, PruFund business (which provides smoothed investment returns to customers with limited guarantees), with-profits annuities and non-profit annuities.

RECENT RELEVANT EVENTS

The 2019 Court Process and the Appeal

5.18 As described in paragraphs 1.2 and 1.3, the application to sanction the Scheme in the 2021 Court Process follows the 2019 Court Process and the Appeal.

5.19 I have provided more details of these events in Sections 1 and 3 of this Report.

Acquisition of Ascentric

5.20 Effective from 1 September 2020, M&G plc acquired Investment Funds Direct Limited, trading under the name Ascentric, from the Royal London Group. Ascentric is a digital wrap and wealth management platform.

The Demerger of M&G plc from Prudential plc

5.21 Until 21 October 2019, PAC was part of the Prudential Group, whose parent company is Prudential plc. On 14 March 2018, Prudential plc announced its intention to demerge its UK and European savings and investment business from the rest of the Prudential Group ("**the Demerger**"). At the time of my 2019 Main Report and my 2019 Supplementary Report, the Demerger was planned but had not yet taken place[35].

5.22 The Demerger has now taken place, effective from 21 October 2019; consequently PAC is part of the demerged M&G Group, and is no longer part of the Prudential Group.

[35] While the Demerger had not taken place at the date of my 2019 Supplementary Report, the legal ownership of Prudential plc's Hong Kong insurance subsidiaries, Prudential Hong Kong Limited and Prudential General Insurance Hong Kong Limited, had been transferred from PAC to Prudential Corporation Asia in preparation for the Demerger, with this change of ownership becoming effective on 18 December 2018.

5.23 When announcing the completion of the Demerger, the Chairman of Prudential plc said:

> *"the demerger will help Prudential and M&G to become more closely aligned to the interests of their customers and shareholders. Both businesses will retain their UK domicile and be able to allocate capital even more effectively as separate entities".*

5.24 A simplified structure of the M&G Group is given in Figure 5.1 above.

5.25 PAC and its subsidiaries are the only insurance vehicles in the M&G Group. This is in contrast to the pre-Demerger situation in which there were a number of other large insurance companies within the same group as PAC, specifically Prudential plc's Asian and US insurance businesses.

5.26 The Demerger did not materially affect the financial strength of PAC directly, although the change of ownership of PAC's Hong Kong subsidiaries from PAC to Prudential Corporation Asia in December 2018 (one of the actions taken by Prudential plc to facilitate the Demerger) resulted in a significant reduction in PAC's SCR Coverage Ratio.

The sale of non-profit annuity liabilities to Rothesay

5.27 In March 2018 it was announced that PAC had entered into a business sale agreement (the "**Business Transfer Agreement**") for the sale of a portion of its shareholder-backed non-profit annuity business to Rothesay. This business (the "**Reinsured Business**") was reinsured to Rothesay through a collateralised reinsurance arrangement (the "**Reinsurance Agreement**") as a mechanism to transfer materially the whole of the economic risk of the Reinsured Business pending a full transfer of the business via a Part VII transfer. The Reinsurance Agreement was entered into on 14 March 2018 at the same time as the Business Transfer Agreement.

5.28 As at 31 December 2020, the Reinsured Business comprised approximately 384,000 annuity policies, and it covers both retail and bulk lines of business, including deferred and in-payment annuities, with a total BEL of approximately £12.2 billion as at 31 December 2020.

5.29 Subject to some exclusions (described in paragraphs 7.17 to 7.22), the Scheme provides for the transfer of the policies whose benefits are covered by the Reinsurance Agreement from PAC to Rothesay.

5.30 This sale is described in more detail in Section 6.

Transfer of PAC's non-UK European business

5.31 Effective from 1 January 2019, PAC undertook a Part VII transfer of its long-term insurance business in Poland, France, Malta, Ireland and Germany to PIA.

5.32 This was undertaken in order to allow more efficient operation and to simplify the management of its long-term insurance business across Europe. The transfer was structured to ensure that the PAC policies written through establishments in Europe (excluding the UK) can continue lawfully to be administered and serviced now that the UK has left the EU.

5.33 As part of this transfer, reinsurance arrangements were set up between PIA and PAC to replicate the economic effects of the pre-transfer treatment of the transferring with-profits business.

5.34 It should be noted that, even following this transfer, there are policyholders of PAC who are resident in EEA countries but whose policies were not written through establishments in the EEA.

Previous schemes transferring long-term insurance business into PAC

5.35 As well as the business written directly by PAC, and the business reinsured in from other PAC subsidiaries, there have been a number of transfers of long-term insurance business into PAC:

- Non-profit annuity business transferred into the PAC NPSF from PRIL on 1 October 2016.

- Non-profit annuity business transferred in from Prudential Annuities Limited ("**PAL**") on 1 October 2014. All of the long-term business of PAL was transferred into the PAC WPSF.
- Business transferred in from PHLL and from Prudential (AN) Limited ("**PANL**") on 31 October 2010. All the long-term business of PANL and PHLL was transferred to PAC. All of the non-profit business of PANL and PHLL was allocated to the PAC NPSF and all of the with-profits business of PANL was transferred to the PAC WPSF.
- With-profits annuity business transferred to PAC from ELAS on 31 December 2007, which was principally allocated to the PAC DCPSF.
- Business transferred from SAL to PAC on 31 December 2002. All of the with-profits business was allocated to the PAC WPSF and the rest was transferred to the PAC NPSF.
- Business transferred to PAC from Scottish Amicable Life Assurance Society on 30 September 1997, which was principally allocated to a newly created sub-fund, the SAIF. As described in paragraph 5.9, the SAIF was merged into the PAC WPSF on 1 April 2021.

Proposed transfer of business to Vitality Life Limited

5.36 In November 2014, PAC completed the sale of its remaining stake in the PruHealth/PruProtect joint venture with Discovery Limited ("**Discovery**"). As a consequence of this, Discovery and PAC agreed that the protection business written by PAC, on behalf of the joint venture company, would be transferred to Vitality Life Limited, Discovery's UK life insurance company.

5.37 This Part VII transfer has, for the time being, been deferred, and PAC has not yet determined the timescales for its completion.

5.38 However, PAC has informed me that the implementation of this Part VII transfer would have a negligible effect on the Solvency II financial position of PAC.

PAC'S REINSURANCE ARRANGEMENTS

5.39 PAC has a reinsurance arrangement in place with PIA under which 100% of PIA's with-profits business, including the net cost of options and guarantees, is ceded from PIA to PAC. This reinsured with-profits business is allocated to the PAC WPSF and the PAC DCPSF.

5.40 In addition to the Reinsurance Agreement with Rothesay, PAC has outwards reinsurance arrangements with the counterparties listed below[36]; these include longevity reinsurance contracts that cede a material proportion (covering approximately £12 billion of liabilities as at 31 December 2020) of the longevity risk in respect of the annuities in the PAC NPSF.

- Aberdeen Asset Management
- BlackRock Life Limited
- Cologne Re
- Gen Re
- Hannover Re
- Legal & General

[36] Group or brand names have been used in some cases for PAC's reinsurance counterparties, rather than the name of the specific legal entity with which the reinsurance is held.

- Munich Re
- Pacific Life Re
- PartnerRe
- Pinnacle Insurance Plc
- Prudential Financial[37]
- RGA
- SCOR SE
- Standard Life
- Suffolk Life Annuities Ltd
- Swiss Re

REGULATORY APPROVALS

5.41 PAC has approval from the PRA for the use of the Matching Adjustment and the TMTP in the derivation of its Solvency II Financial Condition.

5.42 PAC also has approval for the use of its internal model to derive its SCR.

FINANCIAL CONDITION

5.43 I have considered both the Solvency II Pillar 1 and Pillar 2 (economic capital)[38] financial positions of PAC in my assessment. I am unable to disclose details of the Pillar 2 financial position, as this is submitted privately to the PRA, but have used this information in my assessment of the risk profile, as well as the recent and expected future development of the business of PAC, which are covered in paragraphs 5.31 to 5.38, and paragraphs 5.68 to 5.69. I can confirm that the Pillar 2 position shows a significantly greater level of excess capital than the Pillar 1 figure (albeit based on financial positions at 31 December 2019), and I understand that this is expected to remain the case at 31 December 2020[39].

[37] Prudential Financial, Inc. is a financial services group headquartered in New Jersey, USA, which is not connected with M&G plc or Prudential plc.

[38] PAC maintains an internal view of its capital needs through the calculation of its 'economic capital requirement' as part of its ORSA process

[39] I will comment on the 31 December 2020 Pillar 2 position in my 2021 Supplementary Report.

TABLE 5.4 – PAC SOLVENCY II PILLAR 1 BALANCE SHEET AT 31 DECEMBER 2020

PAC Solvency II Pillar 1 Balance Sheet	PAC SHF	NPSF	Value of PAC's interest in its subsidiaries	Total PAC Shareholder-Backed Business	PAC With-Profits Fund	Consolidated PAC
	£m	£m	£m	£m	£m	£m
Solvency II Assets (net of other items)	2,608	47,940	9,157	59,704	136,163	186,174
Technical Provisions (including TMTP)	-	42,266	8,721	50,987	124,267	172,561
Own Funds (A)	**2,608**	**5,674**	**436**	**8,718**	**11,896**	**13,613**
SCR (B)	1,660	3,765	(318)	5,107	4,895	10,002
Excess Capital (=A – B)	948	1,908	754	3,611	7,001	3,611
SCR Coverage Ratio (=A/B)				***171%***	***243%***	***136%***

Notes:

- The Technical Provisions are determined as BEL plus Risk Margin minus TMTP, e.g. for the PAC NPSF this is derived as the BEL of £41,739 million (as shown in Table 5.3) plus a Risk Margin of £1,999 million minus the TMTP of £1,472 million.
- The figures for the PAC With-Profits Fund represent PAC's economic view of the Solvency II balance sheet for the with-profits business, including the liability and associated capital requirements related to the present value of the future shareholder transfers.
- These figures are calculated using PAC's reported TMTP as at 31 December 2020. Changes in economic conditions can change the difference between Solvency I and Solvency II Technical Provisions (which is the basis for the calculation of the TMTP),but use of an updated TMTP would require a formal recalculation of the TMTP to be approved. PAC has no plans to formally recalculate the TMTP before the proposed transfer and so all figures presented will use the reported TMTP rather than a "dynamic" TMTP that moves in line with economic conditions.
- The PAC SHF does not have any Technical Provisions; it comprises solely:
  - the asset representing the value of the shareholder's interest in future transfers ("**SHIFT**") from the PAC With-Profits Fund[40];
  - the value of derivatives put in place to partially hedge the value of the SHIFT asset; and
  - the accounting value of the staff pension scheme.

  The PAC SHF's SCR is primarily related to the risk of a reduction in the value of the SHIFT asset as a result of a fall in the value of equities held in the PAC WPSF.
- The value of PAC's interest in its subsidiaries is calculated as a balancing item (i.e. the Total PAC Shareholder-Backed Business minus the PAC SHF and NPSF). Therefore, the SCR shown is not necessarily reflective of the reported SCRs for the subsidiaries in isolation.
- Where appropriate, the impact of reinsurance arrangements and loans between PAC and its subsidiaries has been eliminated to avoid double-counting of assets and liabilities.

5.44 In this Report, PAC's financial information has been provided on two bases which differ in their treatment of the PAC With-Profits Fund, in particular:

- **The financial position for the PAC Shareholder-Backed Business only**. In this presentation, only the surplus and capital requirements relating to the PAC With-Profits Fund that are directly attributable to the PAC Shareholder-Backed Business flow through to the financial position; and
- **The consolidated regulatory solvency position of PAC.** In this presentation, the full SCR of the PAC With-Profits Fund is included in the overall PAC capital requirements, but the surplus assets of the PAC With-Profits Fund in excess of this SCR are not included in the PAC surplus assets as these assets are deemed

[40] The PAC Shareholder-Backed Business is entitled to receive certain transfers of assets from the PAC With-Profits Fund, for example shareholder transfers upon the addition of discretionary bonuses to with-profits policies in the PAC WPSF, and therefore PAC holds an asset representing the value of these future transfers on the balance sheet of the PAC Shareholder-Backed Business. The SCR of the PAC Shareholder-Backed Business includes a component corresponding to the risks to the PAC Shareholder-Backed Business arising from the PAC With-Profits Fund, for example the risk of lower-than-expected future shareholder transfers, or the risk that shareholder support will be required to be provided to the PAC With-Profits Fund.

to be attributable to the with-profits policyholders of the PAC With-Profits Fund rather than the PAC shareholder.

5.45 The transfer will not materially affect the solvency position of the PAC With-Profits Fund, and therefore in illustrating its impact on solvency I have focused on the position of the PAC Shareholder-Backed Business. However, in extreme circumstances, for example, if PAC were to become insolvent, the assets of the PAC Shareholder-Backed Business may be needed to support the liabilities of the PAC With-Profits Fund. Because of this, it is also important to consider PAC's consolidated regulatory solvency position.

5.46 It should be noted that neither presentation of PAC's financial position takes credit for the significant level of surplus assets that are present in the PAC With-Profits Fund. This approach is consistent with the Solvency II rules and arises because the with-profits sub-funds of the PAC With-Profits Fund are ring-fenced, and therefore surplus assets in those funds are held for the benefit of PAC's with-profits policyholders and would only be available to support business outside of the PAC With-Profits Fund in extreme circumstances, the precise nature of which is untested but may include, for example, a scenario in which the assets of the PAC Shareholder-Backed Business were insufficient to meet its liabilities to policyholders.

5.47 At 31 December 2020, PAC's consolidated regulatory SCR Coverage Ratio was 136%, and that of the PAC Shareholder-Backed Business was 171%, which are both significantly in excess of the minimum regulatory requirement of 100%.

CAPITAL STRUCTURE

5.48 PAC's available Own Funds at 31 December 2020 comprised entirely Tier 1 items, and therefore there are no restrictions on the extent to which PAC's available Own Funds are eligible to cover its SCR and MCR.

FINANCIAL STRENGTH RATINGS

5.49 PAC has been reviewed by three credit ratings agencies and been assigned the following ratings:

- **Moody's**: rated Aa3 ("high quality and subject to very low credit risk") as at 5 March 2021;
- **Fitch**: rated AA- ("very high credit quality") as at 7 September 2020;
- **Standard & Poor's**: rated A+ ("somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitments on the obligation is still strong.") as at 24 August 2020.

RISK AND CAPITAL MANAGEMENT

5.50 The PAC Board is responsible for the management of PAC's exposure to risk and in particular:

- Determining PAC's risk appetite and therefore its capacity for risk.
- Managing the overall risk level of the company having regard to the capacity for risk and the internal capital management policy.

5.51 PAC's risk appetite statement for the PAC Shareholder-Backed Business is set out in PAC's Shareholder Risk Appetite ("**SRA**") Framework and defines the level of capital buffer that the PAC Board has determined that PAC should aim to hold in excess of its Solvency II Pillar 1 SCR and its Solvency II Pillar 2 economic capital requirement. This level of capital is expressed as a ratio of the available capital to the capital requirement (the ratio of Eligible Own Funds to the SCR in the case of Pillar 1).

5.52 PAC's SRA Framework also includes a "**solvency intervention ladder**" which sets out solvency triggers to consider and initiate actions to manage and restore the capital position as solvency deteriorates. To avoid taking unnecessary pro-cyclical management actions, the framework requires consideration of the point in the economic cycle and its impact on the capital position. The determination of the point in the cycle is made by the PAC Board based on a number of inputs including economic cycle indicators, which reflect the risk profile of the business, and expert advice.

5.53 The SRA Framework capital buffer and the triggers on the solvency intervention ladder are updated twice-yearly.

5.54 The PAC Board is required to approve any changes to the framework. Proposals are initially tabled at the Executive Risk Committee and Board Risk and Capital Committee ("**BRCC**"), a sub-committee of the Board which assists the Board in meeting its responsibility for overseeing the effectiveness of risk and capital management. The BRCC reviews and recommends proposals to the Board, which then approves any changes. Any material changes to the framework are shared with the PRA.

5.55 To help ensure that PAC remains within the requirements of its SRA Framework, the Board manages the type and volume of new business accepted having regard to the available capital resources in PAC.

5.56 PAC also has a risk appetite statement for the PAC With-Profits Fund.

5.57 The SRA Framework is confidential and not in the public domain. Therefore, the specific details of PAC's SRA Framework have not been included in this Report, but I have been provided with these details by PAC and considered the SRA Framework when assessing the financial impact of the Scheme.

5.58 PAC has extensive recovery and resolution plans in place to complement the high-level actions outlined in the SRA framework. Both plans are updated at least annually.

SHAREHOLDER EXPOSURE TO PAC'S WITH-PROFITS FUND

5.59 PAC is required to meet its obligations to policyholders of the PAC With-Profits Fund even if the assets allocated to this fund are insufficient for this purpose. The assets in each of the sub-funds of the PAC With-Profits Fund in excess of amounts expected to be required to meet guaranteed benefits and future discretionary benefits of business in that sub-fund, as well as related shareholder transfers (the "**excess assets**"), could be materially depleted over time by, for example, significant changes in financial market conditions, costs of fundamental strategic change or a material increase in PAC's provision in relation to pensions mis-selling.

5.60 In the unlikely circumstance that the depletion of the excess assets within one or more of the ring-fenced with-profits sub-funds was such that the ability of PAC and the wider M&G Group to meet policyholders' reasonable expectations was adversely affected, it might become necessary to restrict remittances to shareholders or to provide financial support to the PAC With-Profits Fund using capital resources of the PAC Shareholder-Backed Business. This is considered in more detail in Sections 7 and 8.

THE PAC PENSIONS MIS-SELLING COSTS ASSURANCE

5.61 The UK insurance regulator required all UK life insurance companies to review personal pension policies sold between 29 April 1988 and 30 June 1994, and to provide redress in all cases where the policyholder was assessed to have suffered a financial loss as a result of leaving, or not joining, an alternative pension arrangement sponsored by an employer or the UK Government[41]. Compensation to all policies affected by mis-selling was provided by 30 June 2002[42]. Costs arising from the review of policies in the PAC WPSF were met by excess assets of that fund and so have not been charged to the asset shares used in the determination of policyholder bonus rates.

[41] Except in the cases where the provider was able to evidence a fully compliant sales process.

[42] For some policies, the final compensation amount will be dependent on the value of the policy at retirement.

5.62 PAC has given an assurance, known as the "**Pension Mis-Selling Costs Assurance**", that these deductions from excess assets will not affect its bonus or investment policy for policies within the PAC With-Profits Fund that were in force at 31 December 2003. This assurance does not apply to new business since 1 January 2004. In the unlikely event that such deductions would affect the bonus or investment policy for the relevant policies, PAC has stated it would make available support to the relevant with-profits sub-fund from shareholder resources for as long as the situation continued, so as to ensure that those policyholders were not disadvantaged.

CAPITAL SUPPORT AVAILABLE TO PAC

5.63 Prior to the Demerger a capital support arrangement ("**CSA**") was in place between Prudential plc and PAC, under which Prudential plc was obliged, subject to a cap, to provide PAC with additional capital support in the event of PAC's solvency falling below specified levels. The capital support provided under the CSA included the resources that might be required to support the PAC Pension Mis-Selling Costs Assurance in relation to with-profits business, as described above.

5.64 The CSA terminated on 21 October 2019 following the Demerger, at which time new arrangements formalising the circumstances in which M&G plc would make capital support available to PAC became effective. I have been provided with further details of these arrangements but they are confidential and I am therefore not permitted to disclose these details in this Report; I have, however, taken them into account in my assessment of the proposed transfer.

5.65 While I am not permitted to disclose details of capital support arrangements within the M&G Group, I have been informed by PAC's management that, at 31 December 2020, the total liquid assets held by M&G plc were approximately £1.0 billion.

ADMINISTRATION AND OUTSOURCING

5.66 Until 30 September 2018, the policies within the scope of the transfer were administered by PAC and other group companies using in-house systems.

5.67 On 12 June 2018, PAC announced that its strategic partnership with Tata Consultancy Services ("**TCS**") and Diligenta, its UK subsidiary, would, from 1 October 2018, be extended to include PAC's annuity business. Consequently, since that date, PAC has outsourced the policy administration for the Transferring Policies to TCS/Diligenta.

RISKS INHERENT IN PAC

5.68 The most significant risks to the PAC Shareholder-Backed Business are:

- **Market risk**: This primarily comprises risks such as adverse changes in equity prices, property prices, bond prices and currency exchange rates on the value of future shareholder transfers expected to be received from the PAC With-Profits Fund.
- **Default / downgrade risk**: This primarily arises as a result of the substantial volume of corporate bonds held to back non-profit annuity liabilities.
- **Insurance risk**: This is a material risk, with longevity risk on non-profit annuity liabilities being the most significant component.

5.69 The PAC With-Profits Fund is materially exposed to market risk arising from the mismatch between assets backing the asset shares and guarantees embedded in the corresponding liabilities. Credit risk within the PAC With-Profits Fund primarily arises due to the substantial volume of corporate bonds in the capital funds, asset share funds and backing non-profit annuities that are held in the PAC With-Profits Fund. Insurance risk is also material to the ring-fenced funds, in particular longevity risk and expense risk.

6. Background to Rothesay

BACKGROUND

6.1 Rothesay was established as a private company limited by shares on 26 February 2007, as a wholly owned subsidiary of Rothesay Life (Cayman) Limited. It was previously known as Hackremco (No. 2460) Limited (until 14 March 2007) and First Premium Company Limited (until 14 May 2007) and Rothesay Life Limited (until 24 March 2016).

6.2 Until 2013, Rothesay's ultimate parent company was The Goldman Sachs Group, Inc. ("**Goldman Sachs**") but, in December 2013, Goldman Sachs completed a partial sale of Rothesay, introducing three additional shareholders. As part of the deconsolidation from Goldman Sachs, Rothesay HoldCo UK Limited ("**Rothesay HoldCo**") was introduced as a holding company between Rothesay Life (Cayman) Limited and Rothesay. During 2016 Rothesay also established an Employee Benefit Trust to purchase and hold shares of Rothesay HoldCo for delivery to employees under employee share schemes.

6.3 In 2017, Goldman Sachs sold all its remaining Rothesay HoldCo shares to The Blackstone Group L.P. ("**Blackstone**"), Government of Singapore Investment Corporation ("**GIC**") and MassMutual Financial Group ("**MassMutual**").

6.4 Rothesay HoldCo was renamed Rothesay Limited on 8 October 2020.

6.5 Effective from 1 December 2020, Blackstone sold its 36% stake in Rothesay Limited to GIC and MassMutual, resulting in GIC and MassMutual each becoming equal 49% shareholders.

6.6 Rothesay is a wholly owned subsidiary of Rothesay Limited, which in turn is owned by:

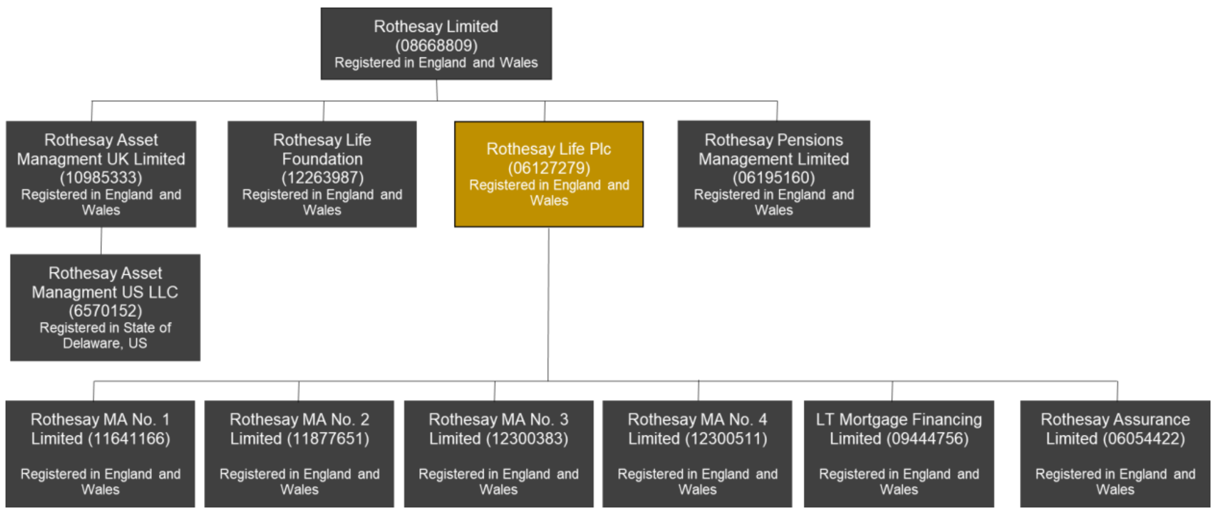
- GIC;
- MassMutual; and
- Management, Employees and Elian Employee Benefit Trustee Limited.

6.7 Rothesay became a Plc in March 2016.

6.8 Rothesay is the only regulated insurance company within the Rothesay Limited group of companies, but Rothesay Limited has several other subsidiaries. Rothesay itself also has a number of subsidiaries, which are service companies principally used as vehicles to restructure certain investments to create investments that are eligible for inclusion in Rothesay's Matching Adjustment Portfolio.

6.9 Rothesay's ownership structure as at 31 December 2020, with Rothesay highlighted gold, is shown in the chart below.

FIGURE 6.1 – STRUCTURE OF ROTHESAY HOLDCO GROUP OF COMPANIES



6.10 Rothesay has permission to effect and carry out insurance business of Classes I (life and annuity), III (linked long term), IV (permanent health) and VII (pension fund management), as set out in Part II of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

PRODUCTS

6.11 Rothesay's long-term insurance business comprises non-profit pension business originating in the UK; more specifically:

- Bulk purchase annuity contracts issued to trustees of UK defined benefit pension schemes by way of a buy-in policy;
- Individual policies issued to former members of UK defined benefit pension schemes as a consequence of a buyout of their benefits by Rothesay;
- Individual retail annuity policies acquired from Zurich Assurance Ltd and Scottish Equitable plc (see paragraphs 6.25 and 6.26); and
- Longevity swaps (also known as longevity insurance) provided to UK defined benefit pension schemes.

6.12 In addition, as described in the previous section and below, Rothesay has also entered into the Reinsurance Agreement with PAC covering certain retail and bulk annuity business, with a view to formalising the transfer of the relevant business from PAC to Rothesay via the Scheme.

6.13 Rothesay's individual policyholders and the members of occupational pension schemes subject to buy-in or longevity insurance arrangements with Rothesay are a mixture of deferred and in-payment pensioners.

6.14 Rothesay insures the pensions of approximately 845,000 individuals[43], and had Technical Provisions of £54.4 billion[44] at 31 December 2020.

6.15 The liabilities of Rothesay are generally for the payment of guaranteed annuity amounts, either level or increasing at a fixed rate or in line with a specified inflation measure, payable either for the lifetime of the original pension scheme member/insurance company policyholder or to their dependants on a contingent basis.

RECENT RELEVANT EVENTS

The 2019 Court Process and the Appeal

6.16 As described in paragraphs 1.2 and 1.3, the application to sanction the Scheme in the 2021 Court Process follows the 2019 Court Process and the Appeal.

6.17 I have provided more details on these events in Section 7 of this Report.

Reinsurance with PAC

6.18 As described in paragraphs 5.27 to 5.30, in March 2018 it was announced that PAC had entered into a transaction to transfer the Reinsured Business to Rothesay. As at 31 December 2020, the Reinsured Business comprises

[43] Including the PAC policyholders whose annuities are reinsured to Rothesay from PAC.

[44] Inclusive of the c.£11.7 billion inwards reinsurance from PAC, described in paragraph 6.18. The figure of £11.7 billion is the BEL held by Rothesay in relation to the reinsured business, whereas £12.2 billion is PAC's BEL (gross of reinsurance) in relation to the reinsured business. There are two material components of the difference between these figures. The first is that the Transferring Business is not part of PAC's Matching Adjustment portfolio (and therefore its BEL is not calculated using the Matching Adjustment), whereas the inwardly reinsured business in Rothesay under the Reinsurance Agreement is part of Rothesay's Matching Adjustment portfolio, which means that Rothesay's BEL is calculated using a discount curve that includes a Matching Adjustment, resulting in a higher discount rate and a lower BEL. The second is that £12.2 billion represents PAC's BEL, gross of the longevity reinsurance arrangements, whereas Rothesay's figure of £11.7 billion represents the value of Rothesay's liability to PAC net of the impact of longevity reinsurance arrangements held by PAC; Rothesay's equivalent to the £12.2 billion is £11.2 billion.

approximately 384,000 policies, covering both retail and bulk lines of business including deferred and in-payment annuities. The Reinsured Business has been reinsured to Rothesay through a collateralised reinsurance arrangement. The Reinsurance Agreement was entered into on 14 March 2018 and reinsures the policyholder benefit liabilities of the Reinsured Business from PAC to Rothesay.

6.19 Assets providing collateral for Rothesay's obligations to PAC under the Reinsurance Agreement are held in custody accounts. Under the terms of the Reinsurance Agreement, the bulk of the assets in the custody accounts must comply with the relevant Matching Adjustment rules and tests, i.e. they must comply with the relevant aspects of Regulation 42 of Chapter 2 of Part 4 of The Solvency 2 Regulations 2015, and the relevant PRA matching tests in respect of the liabilities of the Reinsured Business[45].

6.20 In addition, PAC and Rothesay entered into a transfer agreement (the "**Business Transfer Agreement**") and a supplemental agreement (the "**Supplemental Agreement**") at the same time as the Reinsurance Agreement. This sets out how the Reinsured Business will be transferred to Rothesay by way of a Part VII transfer under the FSMA. However, as described in Section 7, there have been some subsequent additions and exclusions to both the Reinsured Business and the business that will be transferred to Rothesay under the Scheme.

6.21 If the Scheme proceeds to completion as intended, the Reinsurance Agreement will be modified to cover only the Non-Transferring Reinsured Policies (see paragraph 7.20), which are not in scope of the Scheme, and any Excluded Policies. With the exception of collateral required to facilitate the continuing reinsurance of the Non-Transferring Reinsured Policies, and any Excluded Policies (see paragraph 7.17), the associated collateral held in custody will be released to Rothesay.

6.22 The Reinsurance Agreement gives PAC the option to recapture the reinsured business if the Scheme has not become effective by 31 March 2021. In light of the delay to the originally envisaged timescales, this date has passed and therefore PAC now has the option of recapturing the reinsurance should it so wish. In this scenario, Rothesay would pay an agreed amount to PAC and PAC would regain the economic interest in the business covered by the Reinsurance Agreement. PAC also has the right to recapture the reinsurance in a number of other circumstances. The amount to be paid by Rothesay to PAC as a result of such a recapture would depend on the trigger for the recapture. Rothesay also has the right to require recapture of the reinsurance by PAC in certain, limited circumstances.

Other relevant events

6.23 In January 2011, Rothesay acquired Paternoster UK Limited ("**Paternoster**"), an insurance company specialising in bulk annuity business, and on 19 December 2011 the Court approved the Part VII transfer of the long-term business of Paternoster into Rothesay.

6.24 On 16 May 2014, Rothesay completed the purchase of MetLife Assurance Limited ("**MAL**"), another bulk annuity specialist, from MetLife European Holdings Limited. MAL became a wholly owned subsidiary of Rothesay and changed its name to Rothesay Assurance Limited ("**RAL**") on 23 June 2014. On 30 November 2015 the business of RAL was transferred into Rothesay by way of a Part VII transfer.

6.25 In April 2015, December 2015, June 2016 and November 2016, four tranches of annuity business originally written by Zurich Assurance Ltd were inwardly reinsured by Rothesay. All Zurich policies reinsured with Rothesay were transferred to Rothesay by way of a Part VII transfer in June 2017.

6.26 On 11 April 2016 Rothesay agreed to inwardly reinsure a significant part of the non-profit annuity portfolio of Scottish Equitable plc (a subsidiary of Aegon N.V.). The transaction was completed by way of a Part VII transfer of the reinsured policies from Scottish Equitable plc to Rothesay in June 2017.

6.27 On 1 April 2019 it was announced that the Monument Re Group had agreed to acquire a portfolio of Irish annuities from Rothesay. The transaction was structured initially as a reinsurance agreement under which the portfolio was

[45] The Reinsurance Agreement specifies that the collateral must "comply with the PRA matching tests set out in the Appendix of the PRA Consultation Paper (CP 21/17) on Matching Adjustment, dated October 2017"; these tests have since been formalised, with some minor amendments, as part of the PRA Supervisory Statement (SS 7/18) dated July 2018.

100% reinsured to Monument Re Limited, followed by a Part VII transfer of the portfolio from Rothesay to Monument Life Insurance DAC (an insurance company within the Monument Re Group). The Part VII transfer was sanctioned by the Court on 31 July 2020 and was implemented on 7 September 2020. The purpose of the transaction was to ensure that Rothesay continued to meet its legal requirements whatever the outcome of the Brexit process.

OUTWARDS REINSURANCE ARRANGEMENTS

6.28 Rothesay outwardly reinsures approximately 70% of its longevity risk through longevity reinsurance contracts with a range of reinsurers. Currently, Rothesay has outwards reinsurance agreements with the following companies:

- Canada Life Reinsurance
- Challenger
- Hannover Re
- Massachusetts Mutual Life
- MetLife
- Munich Re
- Pacific Life Re
- Prudential Financial
- Royal Bank of Canada
- RGA
- SCOR
- Swiss Re
- XL

REGULATORY APPROVALS

6.29 Rothesay has approval from the PRA for the use of the Matching Adjustment and the TMTP in the derivation of its Solvency II Financial Condition.

6.30 Rothesay also has approval for the use of its PIM to derive the component of its SCR that relates to counterparty default and spread risk. All other components of its SCR are derived using the Solvency II Standard Formula. In addition, Rothesay has agreed with the PRA to hold an add-on to its SCR in relation to risks not covered by its PIM and not covered by the Solvency II Standard Formula, in particular:

- Inflation risk, i.e. the risk of adverse levels of future inflation, or adverse changes to expectations in relation to future inflation, and its effects on Rothesay's inflation-linked liabilities (see paragraph 4.76); and
- The risk that a higher proportion of pensioners than assumed have dependants[46].

6.31 Rothesay is currently developing a full internal model that will cover all risks to which it is exposed. This full internal model will be subject to PRA approval, and will not be in place in advance of the Transfer Date. Rothesay anticipates that the full internal model will, subject to PRA approval, become operational during 2022.

FINANCIAL CONDITION

6.32 I have considered both the Solvency II Pillar 1 and Pillar 2 financial positions of Rothesay in my assessment. I am unable to disclose details of the Pillar 2 financial position, as this is submitted privately to the PRA, but have used this

[46] Dependants of members of occupational pension schemes are often eligible to receive a dependant's pension if the member predeceases them. Insurers of defined benefit pension liabilities (including Rothesay) often do not have sufficient information on the underlying scheme members to determine if any given member has such an eligible dependant. Rothesay therefore makes an assumption in relation to the proportion of its policyholders who have such a dependant, but to the extent that this assumption turns out to be incorrect, Rothesay's actual liabilities could be higher than assumed in its BEL because of the additional pensions it will be required to pay to these dependants. Rothesay therefore holds capital (in the form of the add-on agreed with the PRA) against the risk that its assumption is incorrect, as this risk is not covered by the Standard Formula SCR.

information in my assessment of the risk profile and expected future development of Rothesay; a description of Rothesay's risk profile is provided in paragraph 6.55. I can confirm that Rothesay's Pillar 2 position at 31 December 2020 shows a significantly greater level of excess capital than the Pillar 1 figure.

TABLE 6.2 – ROTHESAY SOLVENCY II PILLAR 1 BALANCE SHEET AT 31 DECEMBER 2020

	Rothesay
	£m
Solvency II Assets (net of other items)	61,742
Technical Provisions (including TMTP)	54,389
Own Funds (A)	**7,353**
SCR (B)	3,623
Excess Capital (=A - B)	3,730
SCR Coverage Ratio **(=A÷B)**	***203%***

6.33 The SCR Coverage Ratio for Rothesay as at 31 December 2020 was 203% (31 December 2019: 201%). Rothesay aims to operate at a level of cover within a range of 130% to 150%, as described in paragraph 6.46.

6.34 As described above, Rothesay's Solvency II financial position (both pre- and post-Scheme) uses the Matching Adjustment and the TMTP, and Rothesay uses its PIM to derive its capital requirements in relation to counterparty default risk and spread risk, with all of the other components of Rothesay's SCR derived using the Solvency II Standard Formula plus an add-on (see paragraph 6.30).

CAPITAL STRUCTURE

6.35 Rothesay's available Own Funds as at 31 December 2020 comprise the following:

- Tier 1 capital resources of £5.9 billion;
- Tier 2 capital resources of £1.0 billion; and
- Tier 3 capital resources of £0.5 billion.

6.36 Rothesay's Tier 1 capital resources comprise paid-in ordinary share capital and a reconciliation reserve, which is the excess of Rothesay's assets over its liabilities after deduction of the Rothesay's other sources of Tier 1, Tier 2 and Tier 3 capital resources.

6.37 Rothesay's Tier 2 and Tier 3 capital resources comprise a number of debt instruments in which investors rank higher than Rothesay's equity investors, but for which interest and principal payments are deferred or cancelled if Rothesay's SCR Coverage Ratio falls below 100%. In effect this means that interest and principal payments on the debt rank below obligations to Rothesay's policyholders (both direct policyholders and inwardly reinsured business) in terms of priority for payment.

6.38 The levels of Rothesay's Tier 2 and Tier 3 capital resources are not high enough to trigger any restrictions on their eligibility to meet Rothesay's SCR (see paragraph 4.19).

FINANCIAL STRENGTH RATINGS

6.39 Rothesay has been reviewed by two credit ratings agencies and been assigned the following ratings:

- **Moody's**: rated A3 ("upper-medium grade and subject to low credit risk") with a "positive" outlook, as at 21 June 2021; and
- **Fitch**: rated A+ ("high credit quality") as at 11 June 2021.

RISK AND CAPITAL MANAGEMENT

6.40 Rothesay maintains a Risk Management Framework ("**RMF**") that is designed to identify, measure, manage, monitor and report significant risks that threaten the achievement of its business objectives.

6.41 The RMF informs and is directed by Rothesay's business strategy. Therefore, the Rothesay's risk management principles are driven by the key objectives of the business. These are:

- to ensure that Rothesay's liabilities to policyholders can be met in a full and timely manner over a very long-term;
- to maintain Rothesay's financial strength and capitalisation;
- to produce stable earnings from Rothesay's in-force business;
- to protect and increase the value of Rothesay's shareholders' investment; and
- to safeguard Rothesay's reputation.

6.42 Rothesay's risk appetite expresses the types of risk that the Board considers the company should be exposed to in pursuing its business objectives. Strategy risk[47], insurance risk[48] and credit risk are all desired risks which are core to Rothesay's business model. Market risk is a risk which, whilst not desired, is tolerated as a result of the business model but mitigated where possible. Liquidity and operational risks are undesired and Rothesay seeks to eliminate these.

6.43 Rothesay's risk appetite is translated into quantifiable limits and early warning triggers that prompt management action to avoid risk exposures breaching the Rothesay Board's risk appetite.

6.44 Rothesay monitors its risk exposures against its risk appetite and the effectiveness of its intended risk-mitigating management actions on a regular basis. The results are reported to oversight committees and individuals with responsibility for risk management in order to inform business decisions.

6.45 The RMF is subject to regular review to ensure that it remains fit for purpose, and also to an annual confirmation by Rothesay's CRO to that effect.

6.46 Rothesay has an internal capital management policy whereby it targets a Solvency II SCR Coverage Ratio of between 130% and 150% of SCR.

6.47 Outside this target range, the following capital management actions apply:

- If coverage exceeds 150% of SCR, Rothesay considers that is has excess capital that can be deployed or returned to shareholders.
- If coverage is below 130%, then management would take actions to improve the solvency position. Such actions include changing investment mix, putting additional reinsurance in place, suspending the writing of new business, raising capital, or reducing discretionary expenses.

6.48 The capital management policy remains under regular review by the Rothesay Board and any changes to this policy require consultation with the PRA and approval of the Rothesay Board.

[47] The risk of loss in future earnings and capital arising from changes in the competitive, economic, legal or political environment, changing customer behaviour, or a failure to select appropriate strategic or long-term business plans.

[48] Risks to Rothesay's financial position arising from the risk of adverse experience relative to assumptions in the areas of demographics and policyholder behaviour, for example longevity risk.

6.49 Rothesay has extensive recovery and resolution plans in place to complement the high-level actions outlined in the capital management policy. Both plans are updated at least annually.

Revolving credit facility

6.50 Rothesay Limited has access to a revolving credit facility[49] with a current termination date of February 2026 (with two extension options of one year each), which it primarily considers to be a source of emergency liquidity for Rothesay. The available funds under the facility are £420 million. This facility is supported by seven lending banks, and any funds accessed under the facility would be drawn by Rothesay Limited, with the proceeds injected into Rothesay as equity capital. This would have the effect of improving the SCR Coverage Ratio of Rothesay (but not the Solvency II position of Rothesay Limited at the holding company level), as well as providing a source of liquidity.

6.51 Conditions that need to be met in order to draw down on the credit facility are:

- The SCR Coverage Ratio (at both the Rothesay and Rothesay Limited levels) needs to be at least 100%; and
- The leverage ratio[50] at the Rothesay Limited level, determined using a specified methodology, needs to be less than 40%.

ADMINISTRATION AND OUTSOURCING

6.52 Rothesay's business model uses third parties in order to take advantage of economies of scale and external expertise.

6.53 Rothesay outsources (or partially outsources) the following key functions and activities:

- Risk software and some IT provision to Goldman Sachs;
- Pensions administration to Mercer, Capita Employee Benefits and Willis Towers Watson; and
- Middle office operational activity (settlements and collateral management) to Northern Trust.

6.54 Rothesay maintains oversight of these outsourced functions within its operations team in line with its Third Party Oversight Policy.

RISKS INHERENT IN ROTHESAY

6.55 Rothesay considers its main risks to be:

- **Counterparty default and issuer default risk**.
    - Rothesay invests in a combination of relatively illiquid secured lending assets and government-guaranteed and other investment grade[51] bonds. It limits its exposure to default risk by investing in asset classes with suitable security and/or other structural mitigation, as well as through the use of credit protection.
    - Rothesay manages its market risk by investing in low risk asset classes such as government bonds, and by the use of interest rate and inflation swap derivative contracts to match closely the type, amounts and durations of insurance liabilities. However, a material spread risk (see paragraph 4.75) exists, owing to the size of its lending portfolio and Rothesay's investments in unsecured corporate bonds.

[49] A revolving credit facility is a source of credit that can be accessed at short notice, and that can be withdrawn and repaid as required.

[50] At a high level, "leverage ratio" in this context refers to the ratio of the amount of debt to the amount of capital resources (including debt capital).

[51] A bond is considered "investment grade" if its credit rating is the equivalent of BBB or higher.

    - Almost all of Rothesay's longevity reinsurance arrangements are collateralised to reduce its exposure to the risk of default by the reinsurance counterparty.

- **Longevity risk**: Rothesay uses the reinsurance market to significantly reduce its exposure to longevity risk, with approximately 70% of the longevity risk being transferred to third party reinsurers. Nevertheless, longevity risk remains a material risk for Rothesay.

- **Execution, delivery and process management risk**: This is a type of operational risk relating to threats to the delivery of Rothesay's business plan.

- **Regulatory environment and legal risk**: This risk relates to various areas of regulatory or legislative focus. To the extent that insurance regulations or accounting practices change, or there are changes that affect the competitive landscape for providers of pension scheme de-risking, this could adversely (or positively) affect Rothesay's business model, albeit that Rothesay does not believe that there are plausible potential developments that could adversely affect policyholder benefit security.

- **Business disruption and system failure risk**.

6.56 Rothesay's capital structure includes a number of debt issuances, with a total issue amount of £1.8 billion. It does not have material exposure to intra-group loans.

7. The Scheme

THE MOTIVATION FOR THE SCHEME

7.1 In order to facilitate the Demerger and the transfer of ownership of PAC's Hong Kong-domiciled subsidiaries to Prudential Corporation Asia (which was an action taken within the Prudential Group prior to the Demerger) PAC deemed it necessary to reduce the solvency capital requirements of the PAC Shareholder-Backed Business. PAC chose to achieve this by selling part of its large portfolio of non-profit annuities under the Business Transfer Agreement, and transferred materially the whole of the economic risk and reward of the Reinsured Business to Rothesay in 2018 by means of the Reinsurance Agreement.

7.2 At that time, both Companies agreed to seek to transfer the primary obligation (payment of those annuities) to Rothesay so as to give effect to the agreed sale under the Business Transfer Agreement. The intention was that the Reinsurance Agreement would be an interim arrangement pending the completion of that transfer which would then terminate in relation to the Transferring Business[52] as a result. The transfer of the Transferring Business to Rothesay would result in the management of the business being simplified.

7.3 This section describes the features of the Scheme as it now stands for the purposes of the 2021 Court Process. Certain amendments have been made to the Scheme to reflect the passage of time since the 2019 Court Process and the departure of the UK from the EU[53], but the Scheme remains materially unchanged from that which was put before the Court in 2019.

SUMMARY OF THE SCHEME

7.4 The Scheme is expected to be presented to the Court for the 2021 Directions Hearing on 23 July 2021 and for the 2021 Sanction Hearing during November 2021. The purpose of the 2021 Directions Hearing is for the Court to confirm its satisfaction with the Companies' plans for policyholder notification and other relevant matters, and to order that a date be set for the 2021 Sanction Hearing.

7.5 If the Scheme is approved by the Court at the 2021 Sanction Hearing, it will be implemented on the Transfer Date (expected to be before the end of 2021) and, on that date, the Transferring Business will transfer from PAC to Rothesay. The Transferring Business includes the outwards longevity reinsurance arrangements that PAC has in place covering certain of the Transferring Policies; as described in paragraph 7.24; Rothesay will replace PAC as the cedant under these reinsurance arrangements.

7.6 It is not typical for policyholders and other interested parties to attend the directions hearing for a Part VII scheme, as the existence of the scheme is not typically publicised to policyholders until the directions hearing has taken place. However, in this case, the existence of the Scheme is generally known and the Companies have published details of the 2021 Directions Hearing on their respective websites. It is therefore possible that some PAC or Rothesay policyholders will choose to attend the 2021 Directions Hearing, noting that the purpose of that Hearing is to seek the approval of the Court for the Companies' notification proposals and other procedural matters, and not the merits of the Scheme itself. Whether or not policyholders attending the 2021 Directions Hearing will be permitted to participate in that Hearing is a matter for the Court.

7.7 The Jersey Scheme and the Guernsey Scheme will be presented to the relevant courts in Jersey and Guernsey and will be on substantially the same terms as the Scheme. The purpose of these schemes is to ensure that the transfer of the Jersey Policies and the Guernsey Policies is effective, and they will only be effected if the Scheme itself is implemented. If the Jersey Scheme or the Guernsey Scheme is not sanctioned by the relevant court then the corresponding policies that would have been transferred will continue to be reinsured from PAC to Rothesay until such

[52] On completion of the transfer, the Reinsurance Agreement will be modified to cover only the Non-Transferring Reinsured Policies and any Excluded Policies, as defined in paragraphs 7.17 and 7.20.

[53] These amendments reflect, for example, the impact of Brexit on references to relevant legislation and other matters, the fact that certain dates included in the original 2019 Scheme document have now passed, and the fact that the Transfer Date will now be in 2021 and not, as originally envisaged, in 2019.

time as the relevant scheme (amended as appropriate) is sanctioned. Implementation of the Scheme is not contingent on the sanction of either the Jersey Scheme or the Guernsey Scheme.

TRANSFERRING ASSETS AND LIABILITIES

7.8 The Reinsured Business consists of certain non-profit annuities; these are primarily annuities of the PAC NPSF, although a small number of policy benefits that were originally allocated to the PAC WPSF are in the scope of the transfer, as described in paragraph 7.12. The Reinsured Business has been notionally divided into four separate categories, as set out in Table 7.1 below.

TABLE 7.1: BREAKDOWN OF REINSURED BUSINESS AS AT 31 DECEMBER 2020

Category	Description	Number of annuity benefits*	Number of policies	Longevity reinsurance agreement in place?	Gross Solvency II BEL at 31 December 2020 (£ million)**
1	Retail annuities arising from PAC's and SAL's pension business	128,955	128,322	No	3,349
2	Retail annuities primarily written before 2008 by PRIL and annuities arising from PAC's pension business.	100,196	97,902	Yes	2,537
3	Retail annuities primarily written in or after 2008 by PRIL and annuities arising from PAC's and SAL's pension business	114,456	112,442	Yes	3,024
4	Bulk annuities in payment (approximately 75% of the total number of annuity benefits) and in deferment from a range of defined benefit pension schemes written by PAC via buy-in and buy-out transactions	54,126 (in-payment) 15,104 (deferred)	36,885 (in-payment) 8,606 (deferred)	Yes	3,172
Total		**412,837**	**384,157**	**N/A**	**12,081**

**Each annuity policy can have multiple benefits and therefore the number of annuity benefits is greater than the number of policies.*
***The total gross BEL in Table 7.1 is the BEL as calculated by PAC. It is slightly lower than that shown in paragraph 5.28 as the figure in Table 7.1 excludes out-of-model adjustments to the BEL that PAC does not attribute to individual categories.*

7.9 As discussed in paragraph 6.18, PAC reinsured the Reinsured Business to Rothesay under the Reinsurance Agreement. Rothesay's obligations under the Reinsurance Agreement are collateralised, with the assets providing collateral being held in custody accounts. On completion of the transfer, the Reinsurance Agreement will be modified to cover only those policies that are in the scope of the Reinsurance Agreement but that are not in the scope of the Scheme and any Excluded Policies (see paragraph 7.17). It is envisaged that this modified version of the Reinsurance Agreement will remain permanently in place after the Transfer Date, except in the case of any Excluded Policies that are transferred to Rothesay after the Transfer Date. At the same time the balance of the custody accounts will be released from the security arrangements, with the exception of the collateral assets required to facilitate the continuing reinsurance of the Non-Transferring Reinsured Policies and any Excluded Policies.

7.10 The Transferring Business will be the policies that are covered by the Reinsurance Agreement immediately prior to the Transfer Date, other than Excluded Policies and Non-Transferring Reinsured Policies (discussed in paragraphs 7.17 and 7.20 respectively).

7.11 It should be noted that certain policies were added to, or removed from, the originally agreed Reinsured Business in order that the Transferring Business satisfies the following conditions:

- **Policy integrity (member level):** The Transferring Business must contain only whole annuity policies. In cases where one policy has multiple individual benefits, the individual benefits must all be included within the Transferring Business for it to be eligible to be transferred.
- **Policy integrity (scheme level):** For bulk annuity business where multiple annuities have been issued under a single scheme policy, all of the annuities must be included within the Transferring Business for that policy to be eligible to be transferred. This includes any deferred annuities or unvested pensions covered by that policy.
- **Longevity reinsurance integrity:** The Transferring Business must contain all of the benefits within the scope of each of the selected longevity reinsurance contracts, and no benefits within the scope of any other longevity reinsurance contracts. This requirement created a conflict with the need for member level policy integrity described above, as certain annuity policies contain benefits covered by multiple longevity reinsurance contracts. As a result, amendments have been made to the scope of some longevity reinsurance contracts to ensure that all of these requirements can be met.
- **Guaranteed payments:** Policies that comprise only guarantees in payment (i.e. annuities certain[54]), where those benefits are not within the scope of one of the longevity reinsurance contracts, have been excluded from the Transferring Business.
- **Deaths and suspensions:** Policies that terminated as a result of death prior to the date of risk transfer under the Reinsurance Agreement[55] were excluded from the Reinsured Business. Where these policies were to be within the scope of one of the longevity reinsurance contracts, then those policies have been excluded from that longevity reinsurance contract, in line with the relevant contractual arrangements. Suspended policies[56] not covered by one of the longevity reinsurance contracts have been removed from the business in the scope of the Reinsurance Agreement and will not be transferred. Suspended policies covered by one of the longevity reinsurance contracts will remain in the scope of both the Reinsurance Agreement and the Scheme.

7.12 Initially, all business selected to be within the scope of the transfer was shareholder-backed annuity business; this includes benefits from non-profit annuities allocated to the PAC WPSF, the economic interest in which has been transferred to the PAC NPSF through an inter-fund reinsurance arrangement. However, to ensure annuity policy integrity, a small number of benefits[57] of non-profit annuities that were originally allocated to the PAC WPSF were reallocated to the PAC NPSF and included in the Transferring Business as part of the modifications described in paragraph 7.11.

[54] An annuity certain refers to an annuity whose payments are made for a fixed period and whose payments are not contingent on the policyholder's survival. Some annuities include a "guarantee period" feature, which guarantees that the annuity will continue to be paid for at least a fixed period after the inception of the policy, even if the policyholder or policy beneficiary dies during that period. In situations where the policyholder or policy beneficiary is known to have died during the guarantee period, the policy becomes an annuity certain and such policies have been excluded from the Transferring Business.

[55] 1 April 2018 for deferred annuities and 1 July 2018 for annuities in-payment.

[56] Suspended policies are those where annuity payments to the policyholder are paused as the insurer has reason to believe that the policyholder may have died.

[57] 181 annuity policies were transferred from the PAC WPSF to the PAC NPSF. This corresponds to £740,000 in annual annuity payments.

7.13 For the avoidance of doubt, the information in Table 7.1 reflects the scope of the Reinsurance Agreement at 31 December 2020, but allowing for the modifications to that scope described in paragraph 7.11.

7.14 No investments will be transferred from PAC to Rothesay on the Transfer Date; the assets which back the liabilities in relation to the Transferring Business have in large part been funded by the reinsurance premium paid by PAC under the Reinsurance Agreement.

7.15 The number of policies to be transferred (based on business in force as at 31 December 2020) is approximately 353,000; this is lower than the approximately 384,000 policies shown in Table 7.1, which includes 31,000 policies that are in the Reinsured Business but that will not be in the scope of the transfer (as described in paragraphs 7.20 to 7.22). The c.353,000 Transferring Policies account for approximately £10.7 billion of PAC's Solvency II BEL (as at 31 December 2020).

7.16 The Scheme also contains provisions to allow for the possibility that, for technical reasons, some liabilities and assets will need to be transferred after the Transfer Date. These provisions are included within the Scheme as a safeguard, but no such transfer of assets or liabilities is currently envisaged. I am satisfied that any such delays in completing the proposed transfer will not adversely affect policyholders' interests.

EXCLUDED POLICIES

7.17 There is a provision in the Scheme for "**Excluded Policies**". These are policies that are included in the Transferring Business but that are not capable of being transferred at the Transfer Date. Currently, PAC and Rothesay do not anticipate that there will be any Excluded Policies.

7.18 As noted in paragraph 7.7, if the Jersey Scheme or the Guernsey Scheme has not been sanctioned by the relevant court when the Scheme is implemented then the relevant Jersey or Guernsey policies will also be Excluded Policies and will remain reinsured to Rothesay until such time as the applicable Scheme is sanctioned and becomes effective.

7.19 Excluded Policies (if any) will remain subject to a modified version of the Reinsurance Agreement (with effect from the Transfer Date), under which the liabilities of the Excluded Policies will remain reinsured from PAC to Rothesay on a long-term basis.

NON-TRANSFERRING REINSURED POLICIES

7.20 Following entry into the Business Transfer Agreement, the Companies have agreed that a group of policies currently within the Reinsured Business (the "**Non-Transferring Reinsured Policies**") should not transfer as part of the Transferring Business and therefore will not form part of the Transferring Policies within the scope of the Scheme. Instead, these Non-Transferring Reinsured Policies will remain reinsured from PAC to Rothesay on a long-term basis under a modified version of the Reinsurance Agreement (with such amendments as the parties may agree).

7.21 The Non-Transferring Reinsured Policies comprise primarily the following lines of business:

- All deferred annuities within the scope of the Reinsurance Agreement, with the exception of 6 deferred annuity policies. These deferred annuities all arise from one transferring pension scheme which is subject to a buy-in with PAC and which consists mainly of in-payment annuities. In order to facilitate the transfer of this pension scheme, the 6 deferred annuities will form part of the Transferring Policies.
- Annuities arising from Teachers' and NHS additional voluntary contributions ("**AVC**") contracts: For these policies, scheme members benefit from guarantees from the relevant Secretary of State that their pension payments would be protected in the event of default by PAC. This guarantee is expected to be lost in the event of the annuity policy being transferred away from PAC. To avoid this, these policies are excluded from the Transferring Business.

- Annuities arising from Master Trust schemes: There are approximately 600 annuity benefits that arise from a Master Trust scheme for which Prudential Corporate Pensions Trustee Limited acts as the trustee and that are also covered by existing longevity reinsurance contracts (described in paragraph 7.24). These policies have been excluded from the Transferring Business because of the complexity in transferring the business, which is deemed to be disproportionate for the number of policies it would affect.

- Annuities arising from defined benefit and money purchase schemes that have trustees who actively manage the scheme: Some of the benefits of these schemes are covered by the longevity reinsurance contracts that will be transferred to Rothesay as part of the Scheme (described in paragraph 7.24). Consequently, it is not feasible to remove the benefits of these schemes from the business that Rothesay has purchased (as this would necessitate a change to the affected longevity reinsurance contracts) but the benefits of these schemes cannot be transferred to Rothesay as the trustees are still actively managing the schemes.

7.22 PAC and Rothesay have informed me that the Non-Transferring Reinsured Policies described in paragraphs 7.20 and 7.21 are expected to account for approximately £1.4 billion, i.e. around 11% (measured by PAC's Solvency II BEL at 31 December 2020) of the total business in the scope of the Reinsurance Agreement, and approximately 31,000 policies.

7.23 Non-Transferring Reinsured Policies are distinct from Excluded Policies as, unlike Excluded Policies, Non-Transferring Reinsured Policies are not intended to be part of the Transferring Business.

REINSURANCE

7.24 The outwards longevity reinsurance arrangements that PAC has in place covering the Transferring Business will be transferred to Rothesay under the Scheme. These are shown in Table 7.2, along with the relevant exposure[58]:

TABLE 7.2 – OUTWARDS REINSURANCE ARRANGEMENTS APPLICABLE TO THE TRANSFERRING BUSINESS AS AT 31 DECEMBER 2020[59]

Reinsurer	Approximate exposure (£ million)
Pacific Life Re Limited	1,278.6
Pacific Life Re Limited	1,246.0
SCOR Global Life SE – UK Branch	1,106.7
Swiss Re Europe SA – UK Branch	737.8
Prudential Retirement Insurance and Annuity Company[60]	476.8
SCOR Global Life SE – UK Branch	658.4
SCOR Global Life SE – UK Branch	1,191.0
Total	**6,695.3**

7.25 As described in paragraph 7.11, certain amendments were made to the scope of some of the longevity reinsurance treaties to ensure all components of individual policies within the scope of the longevity reinsurance treaties are transferred. No other changes have been made to the longevity reinsurance treaties in anticipation of the transfer, although it should be noted that Rothesay is free to make other administrative changes to the longevity reinsurance treaties after the transfer, subject to agreement with the relevant reinsurer.

7.26 PAC's other external reinsurance arrangements, relating to non-transferring PAC policies, will remain with PAC after the Scheme has been implemented.

[58] "Exposure" refers to the present value of the claims payments expected to be recovered from the reinsurer under the relevant treaty.

[59] Each line represents a different reinsurance treaty and therefore some reinsurers are included multiple times.

[60] Prudential Retirement Insurance and Annuity Company is part of the Prudential Financial group, which is separate from Prudential plc and M&G plc

THEMATIC REVIEW OF ANNUITY SALES PRACTICES LIABILITIES

7.27 In October 2016, the FCA announced the findings of its Thematic Review of Annuity Sales Practices[61] ("**TRASP**"), which assessed whether insurers provided new annuity customers with sufficient information about enhanced annuities[62] at the point of sale. As a result of TRASP, a small number of firms, including PAC, were asked by the FCA to review all non-advised annuity sales from July 2008 and provide redress where appropriate.

7.28 Consequently, PAC has conducted a Past Business Review ("**TRASP PBR**") in relation to the sale of certain annuities. This review has resulted in PAC making lump sum compensation payments ("**TRASP Lump Sums**") and/or augmenting existing annuity payments ("**TRASP Incremental Liabilities**") to certain policies.

7.29 In the case of TRASP Lump Sums, PAC has made these payments to affected policyholders, including any policyholders whose policies are reinsured to Rothesay under the Reinsurance Agreement. PAC does not anticipate that any further TRASP Lump Sums will need to be paid in future.

7.30 In the case of TRASP Incremental Liabilities in relation to policies reinsured to Rothesay under the Reinsurance Agreement, PAC has agreed to pay additional reinsurance premiums to Rothesay to effect the inclusion of the increase to the annuity amounts arising from the TRASP Incremental Liabilities within the scope of the Reinsurance Agreement. Therefore, by the time the Scheme is implemented, Rothesay will be responsible, under the Reinsurance Agreement, for meeting the full annuity amount of all Transferring Policies, including any TRASP Incremental Liabilities, and will remain responsible for this after the implementation of the Scheme.

MIS-SELLING LIABILITIES

7.31 Any residual liabilities from the TRASP PBR are retained by PAC, other than any TRASP Incremental Liabilities that have been reinsured by Rothesay as at the Transfer Date, and are excluded liabilities under the Scheme.

7.32 In addition to the liabilities arising from TRASP PBR described above, PAC will also retain the following liabilities that relate to the risk that policies forming part of the Transferring Business were mis-sold:

- Any penalties or fines, including associated costs and expenses, arising from or in connection with any investigation or disciplinary action undertaken by any regulator;
- Any mis-selling liabilities in relation to policies in Category 1, 2 or 3 of the Transferring Business crystallising (or of which Rothesay has given notice to PAC) prior to 31 December 2026; and
- Any mis-selling liabilities in relation to policies in Category 4 of the Transferring Business crystallising (or of which Rothesay has given notice to PAC) prior to 31 December 2019[63].

Categories 1, 2, 3 and 4 are defined in Table 7.1 above (which also includes summary statistics for each category before excluding the Non-Transferring Reinsured Policies).

7.33 Under the terms of the Business Transfer Agreement, residual mis-selling liabilities in respect of the Transferring Business which crystallise after 31 December 2019 or 31 December 2026 (depending on the category of business) will be transferred to Rothesay (regardless of whether the Scheme is implemented) unless Rothesay has notified PAC before such date of the matters or circumstances leading to the relevant mis-selling liability.

[61] https://www.fca.org.uk/publications/thematic-reviews/review-annuity-sales-practices

[62] An enhanced annuity is an annuity sold to individuals where the annuity pricing process includes some underwriting that takes account of the customer's health status or lifestyle factors (such as smoking), resulting in a higher annuity amount being offered than would otherwise be available.

[63] Category 4 exclusively contains non-retail bulk annuity business, unlike Category 1, 2 and 3 which are composed exclusively of retail business. It has been agreed that the mis-selling liabilities in relation to policies in Category 4 will be transferred to Rothesay based on an earlier crystallisation date than those for the other three Categories; Rothesay considers that non-retail business has a smaller risk of mis-selling than the retail business that comprises Categories 1, 2 and 3.

EXCLUDED LIABILITIES

7.34 In addition, under the Scheme, excluded liabilities will remain with PAC. Excluded liabilities relating to the Transferring Business are defined in the Scheme to include:

- any and all excluded mis-selling liabilities (as described in paragraph 7.32 and 7.33);
- any and all losses arising in connection with a historical administration error of the Transferring Business, made prior to the Transfer Date, which is notified by Rothesay to PAC prior to an agreed date in accordance with the Reinsurance Agreement;
- any and all losses arising from precursor policies[64] in Categories 1, 2 and 3;
- any and all losses arising from precursor policies in Category 4 other than any immediate and deferred annuities that were purchased by a trustee of a defined benefit scheme;
- any and all losses arising from acts or omissions by PAC or any member of the M&G Group before the Transfer Date which are identified within a period of 12 months of the Transfer Date;
- any and all liabilities of PAC under or arising from the Scheme;
- any and all losses arising from fraud by PAC or any member of the M&G Group;
- any losses of PAC in respect of taxation or any taxation arising related to the Transferring Policies that occurs on or prior to the Transfer Date;
- liabilities of PAC under or relating to any third party administration arrangements;
- any liabilities under or relating to Excluded Policies (as described in paragraph 7.19, Rothesay will be liable to PAC in respect of the reinsurance of these policies to Rothesay under a modified version of the Reinsurance Agreement); and
- liabilities under the longevity reinsurance agreements which relate to an act of omission of PAC or breach of the agreements that have accrued or arise in respect of the period prior to the Transfer Date, unless such liabilities crystallise after 31 December 2026 (including where Rothesay has given notice to PAC prior to such date).

METHOD OF SELECTING TRANSFERRING POLICIES

7.35 The business that PAC elected to sell under the Business Transfer Agreement (and consequently to reinsure to Rothesay under the Reinsurance Agreement) was chosen in order to achieve a target level of capital release to support the Demerger. The selection criteria for each category are described below; in each case the target category size at the time was £3 billion of Technical Provisions:

- **Category 1** was designed to comprise retail, non-reinsured non-profit in-payment annuity business. Policies were selected by taking the largest "Scheme ID" categories that were suitable to be transferred, in order, until the required volume of business had been achieved.
- **Category 2** was designed to comprise retail, non-profit in-payment annuity business covered by longevity reinsurance contracts. A selection of longevity reinsurances was identified from those covering business written before 2008 that most closely achieved the target category size.
- **Category 3** was designed to comprise retail, non-profit in-payment annuity business, covered by longevity reinsurance contracts. A selection of longevity reinsurances was identified from those covering business written in or after 2008 that most closely achieved the target category size.

[64] Precursor policies are those that paid (wholly or partially) the premium of a Transferring Policy.

- **Category 4** was designed to comprise bulk, non-profit annuities in payment and in deferment. All shareholder-backed annuity policies written before 2009 were included (with deferred annuities only included if they were administered on a specific administration system). There were also a small number of policies which were included despite being written after 2009. In these cases, the policies were part of pre-2009 pension schemes. In addition some policies were excluded where there were specific circumstances that were considered likely to make it difficult to transfer the scheme.

7.36 In order to finalise the selection of transferring policyholders under the Scheme, a number of modifications were made relative to the categories described above, to ensure that the composition of the Transferring Business meets the commercial requirements agreed between PAC and Rothesay. In addition, modifications, as described in paragraph 7.11, have been made to ensure that the Transferring Business can legally and effectively be transferred by means of the Part VII transfer. This means that the policies in each category may deviate from the selection criteria above.

ADMINISTRATION

7.37 Since 1 October 2018, PAC has outsourced policy administration for the Transferring Business to TCS/Diligenta.

7.38 In order to minimise impact on the policyholders of the Transferring Business and to avoid jeopardising the proposed transfer timelines, PAC and Rothesay have executed a Transitional Services Agreement ("**TSA**") that will come into force upon the implementation of the Scheme, under which PAC will continue to provide administration services (provided by TCS/Diligenta on its behalf) to Rothesay for a period after the Transfer Date. PAC does not expect this to place any additional contractual restrictions on PAC in relation to its outsourcing arrangements for the non-transferring policies.

7.39 The TSA is ready to be implemented in the event of the sanction of the Scheme, and is expected to be in place for a period of 6 to 12 months after the Transfer Date. After this period, Rothesay will transfer the administration of the Transferring Policies to another administrator of Rothesay's choice.

7.40 The TSA states that services provided by PAC during the period of the agreement must be at least to the same standard as the services provided by PAC in the twelve months prior to the Transfer Date.

7.41 The TSA also states that PAC and Rothesay must jointly agree a migration plan within 30 days of the Transfer Date which details how the provision of administration services will be transferred from PAC to Rothesay once the TSA expires, although in practice some of this planning will take place in advance of the transfer. The migration plan must include timetables and milestones relating to the steps required to effect the transfer of the Transferring Policyholder records, the testing of systems and the mapping and loading of data extracts onto Rothesay's administration systems. It must also include safeguards to ensure minimal disruption to PAC's and Rothesay's businesses as well as details of appropriate escalation and governance processes to review and monitor progress of the implementation of the migration plan and any issues encountered. The migration plan must also include an appropriate policyholder communications strategy as well as a process for dealing with complaints, claims or legal action through the period contemplated by the migration plan.

7.42 PAC will retain responsibility for the administration of the Non-Transferring Reinsured Policies and any Excluded Policies after the Transfer Date.

COSTS OF THE SCHEME

7.43 Policyholders will not bear any of the costs associated with the proposed transfer. My Independent Expert fees, the Court fees and Counsel's fees will be shared equally between PAC and Rothesay, as will the costs of any advertisements in respect of the Scheme.

7.44 PAC and Rothesay will each bear the costs of any notifications of their own policyholders of the Scheme[65]. All other costs associated with the proposed transfer will be borne by the party that incurs them.

7.45 The approach to the costs of the Scheme described in paragraphs 7.43 and 7.44 was also followed during the 2019 Court Process and the Appeal.

IDENTIFICATION OF AFFECTED GROUPS OF POLICYHOLDERS

7.46 In this Report I have considered the following groups of policyholders separately:

- Transferring Policyholders;
- Non-transferring policyholders of PAC;
- Existing policyholders of Rothesay.

7.47 Where appropriate I have considered subgroups of the policyholder groups listed in paragraph 7.46, for example in relation to the deferred annuitants within the Transferring Policyholders, or in relation to holders of policies in the PAC With-Profits Fund.

7.48 Given the Transferring Policies are all (with the exception of 6 deferred annuity policies) in-payment annuities subject to the same servicing and administration arrangements, I do not consider that the impact of the Scheme is materially different for different subgroups of the Transferring Policies, other than where explicitly stated.

7.49 For the non-transferring policyholders of PAC, I have considered, where appropriate, the impact of the Scheme on the PAC Shareholder-Backed Business and the PAC With-Profits Fund separately. I do not consider there to be any consequences of the Scheme that would necessitate a more granular consideration of the non-transferring policyholders of PAC.

7.50 For the existing policyholders of Rothesay, given that all policies are non-profit and the Scheme does not affect servicing or administration arrangements, I do not consider there to be any effects of the Scheme that would necessitate a more granular consideration of the existing policyholders of Rothesay.

[65] As described in Section 12 Rothesay wrote to existing policyholders to inform them of the Scheme during 2019, but Rothesay does not intend to send any further notifications related to the Scheme to its existing policyholders, other than to trustees of pension schemes that have entered into buy-in transactions with Rothesay since the 2019 letter was sent.

8. The effect of the implementation of the Scheme on the Transferring Policies of PAC

INTRODUCTION

8.1 In this section I consider the effect of the implementation of the Scheme on the Transferring Policies of PAC.

8.2 As described in Section 6, the Transferring Business comprises non-profit annuities with a Solvency II BEL of approximately £10.7 billion[66] (as at 31 December 2020). The Transferring Business is currently reinsured to Rothesay under the Reinsurance Agreement.

8.3 The Transferring Business does not include the Non-Transferring Reinsured Policies or any Excluded Policies (as defined in paragraphs 7.17 and 7.20). As a result of the implementation of the Scheme, the Transferring Policies will transfer into and become direct policies of Rothesay, and Rothesay will be responsible for meeting the benefits payable under those policies. Transferring Policyholders will be transferred from a long-established company that is a household name to a less well-known company founded fourteen years ago. However, the age and venerability of an insurer do not have a material influence on the security of its policyholders' benefits and the company's ability to meet policyholders' reasonable expectations. The important points to consider in this context are:

- The financial resources available to provide security for the benefits of the Transferring Policies after the implementation of the Scheme compared to those currently available;
- Any change to the profile of risks to which the Transferring Policies will be exposed as a result of the implementation of the Scheme. For example, the transfer will result in Transferring Policies being within a different insurer with a different risk profile to PAC, which means there may be risks that, if they were to manifest, could cause Rothesay difficulties that would not cause PAC difficulties, and vice versa. As the Transferring Business is non-profit, the manifestation of a risk does not affect the policy benefits that Transferring Policyholders are entitled to receive, but it may result in a diminution of the financial resources of the insurer and therefore a reduction in the security for those policy benefits; and
- The effect of the implementation of the Scheme on the reasonable expectations of the transferring PAC policyholders, including benefit expectations, service standards, management and governance that these policyholders should expect for their policies after the implementation of the Scheme.

These are considered in turn below.

THE FINANCIAL RESOURCES AVAILABLE TO PROVIDE SECURITY OF BENEFITS

Sources of security of policy benefits

8.4 The Transferring Policies are currently reinsured to Rothesay. However, PAC remains responsible for paying the benefits due to policyholders; PAC is then paid an appropriate amount by Rothesay under the Reinsurance Agreement to reimburse PAC for the amounts paid to holders of reinsured policies. Should Rothesay be unable to fulfil its obligations under the Reinsurance Agreement, PAC would remain responsible for continuing to pay the benefits (and PAC therefore holds capital, as required by the Solvency II regulations, in respect of the risk that Rothesay is unable to meet its obligations under the Reinsurance Agreement). Therefore, the Transferring Policies currently rely on the available resources of PAC for the security of their guaranteed benefits. Those resources comprise:

- Assets backing the liabilities and capital requirements of the PAC Shareholder-Backed Business; and
- Excess capital resources in the PAC SHF.

[66] This figure excludes Non-Transferring Reinsured Policies (as described in paragraph 7.20), and it is calculated using PAC's methodology and assumptions i.e. using discount rates equal to the PRA's published risk-free rates that are not increased to allow for a Matching Adjustment (see footnote to paragraph 6.14).

8.5 Excess capital resources in the PAC With-Profits Fund also contribute to the security of Transferring Policies to a limited extent but, as noted in paragraph 5.46, they would only become available to support liabilities in respect of those policies in an extreme scenario, for example in the event of PAC's insolvency. Conversely, the PAC With-Profits Fund could also require support from the PAC Shareholder-Backed Business in the event that the PAC With-Profits Fund were in financial difficulty, which is also an extreme scenario. It is not possible to know how material is the level of support that might be provided (in either direction) between the PAC Shareholder-Backed Business and the PAC With-Profits Fund in such a scenario, as it is likely that the capital resources of both funds would have been materially depleted if such an extreme event had occurred. Consequently I have not commented on this scenario using any quantitative analysis, as any such analysis would be highly speculative.

8.6 A significant asset backing the liabilities of the PAC Shareholder-Backed Business is the value of the amounts due to PAC from Rothesay under the Reinsurance Agreement. The ability of Rothesay to fulfil its obligations under the Reinsurance Agreement will therefore affect the financial strength of PAC and therefore security for the benefits of the Transferring Policies will also be provided indirectly by the assets of Rothesay. In particular, the Reinsurance Agreement is fully collateralised with assets that must meet certain eligibility criteria and rules which apply to the management of the collateral held in the custody accounts. If Rothesay were unable to meet its obligations under the treaty then PAC would have recourse to the collateralised assets. This currently contributes to the financial strength of PAC and therefore to the security of the benefits of the Transferring Policies.

8.7 If the Scheme is implemented, the Reinsurance Agreement will cease to apply in respect of the Transferring Policies, all related collateralisation and security features between PAC and Rothesay will fall away and the custody account restrictions will no longer apply. The responsibility for paying benefits to holders of the Transferring Policies will then be with Rothesay, regardless of any onwards reinsurance of those benefits. Holders of Transferring Policies will no longer have any recourse to PAC after the transfer.

8.8 When considering the financial effect of the Scheme, the pre-Scheme balance sheets for PAC and Rothesay will reflect the impact of the Reinsurance Agreement, under which the economic risks and rewards of the Transferring Policies have already been transferred to Rothesay.

The financial strength required under Solvency II

8.9 Under Solvency II the value of assets required to be held in respect of a policy or group of policies is represented by the Technical Provisions (consisting of the BEL and Risk Margin) and the SCR[67]. This required amount is then typically increased in accordance with the firm's capital management policy in order to ensure that a buffer is held over and above the minimum amount required by the Solvency II regulations. In comparing financial strength it is therefore necessary to consider:

- How the Technical Provisions and SCR are determined by the Companies;
- The level of assets held by each of the Companies in excess of the Technical Provisions and SCR; and
- The capital management policy of each of the Companies.

8.10 As would be expected, there are some similarities and differences in the ways that PAC and Rothesay determine their Solvency II Technical Provisions and SCR. For the derivation of the Technical Provisions, both PAC and Rothesay have gained approval from the PRA for the use of the Matching Adjustment (see paragraph 4.28). In PAC's case the Matching Adjustment is used for some of its shareholder-backed immediate annuity business[68], while Rothesay has gained approval for the use of the Matching Adjustment for a much larger proportion of its business.

[67] A description of the relevant aspects of the Solvency II regime is included in Section 4.

[68] Since the inception of the Reinsurance Agreement, the business reinsured to Rothesay under that Agreement is no longer included in the business of PAC to which the Matching Adjustment applies.

The Companies' use of the Matching Adjustment

The long term guarantee measures under Solvency II

8.11 As noted in paragraph 4.13, Solvency II requires Technical Provisions to be determined using market-consistent principles. Market consistency requires the value placed on liabilities to be the amount at which they could be transferred between knowledgeable parties in an arm's length transaction. Under a pure market-consistent approach, cash flows are typically discounted using a risk-free interest rate curve, and the value placed on the liabilities is therefore independent of the assets held to back them. However, there are some aspects of Solvency II that are designed to "ensure an appropriate treatment of insurance products that include long-term guarantees"[69], and which represent a departure from a pure market-consistent approach. These are:

- the Matching Adjustment, which aims to reduce the sensitivity of insurers' financial positions to changes in asset spreads in situations where assets can be held to maturity;
- the Volatility Adjustment, which is designed to mitigate the risk of pro-cyclical behaviour[70] in response to changes in investment conditions; and
- the TMTP, which is intended to facilitate a smooth transition from the Solvency I regulatory regime[71].

These measures are described in Section 4. The effect of each of them is, in almost all circumstances[72], to reduce the level of Technical Provisions of insurers that take advantage of them.

8.12 The introduction of the Matching Adjustment into the EEA (and consequently the UK) regulatory regime has coincided with a period of historically low long-term interest rates, and this is often cited as the catalyst for annuity providers to invest in a wider range of illiquid assets in search of higher risk-adjusted yields that allow them to offer an attractive price for their products, for the benefit of their customers. This increased investment in illiquid assets has resulted in the benefit to annuity providers' solvency positions from the Matching Adjustment rising to significant levels in the UK.

The impact of the use of the Matching Adjustment

8.13 The impact of the use of the Matching Adjustment on an insurer's Solvency II financial position arises in two ways:

- **Impact on BEL:** The Matching Adjustment itself is an increase to the discount rate that may be used in the determination of the insurer's Solvency II BEL (see paragraphs 4.13 and 4.14) for non-profit annuity liabilities. This results, all else being equal, in a lower BEL than would be derived in the absence of the Matching Adjustment;
- **Impact on SCR:**
    - As described above, the use of the Matching Adjustment results in a lower Solvency II BEL. This leads to a knock-on reduction to certain components of the insurer's SCR as, all else being equal, lower liabilities result in a lower SCR.
    - Insurers invested in fixed interest investments such as bonds and loans are required to hold capital against the spread risk associated with those assets (see paragraph 4.75). However, insurers using the Matching Adjustment are permitted to assume that the impact of an increase in asset spreads (which would cause a reduction in the insurer's asset values) would be partially offset by an increase in the Matching Adjustment (which would cause a reduction in the insurer's BEL), resulting in a lower

[69] EIOPA Report on long-term guarantee measures and measures on equity risk (2016)

[70] Pro-cyclical behaviour typically refers to situations in which movements in investment markets lead to forced asset purchases or sales, which can serve to exacerbate the market movements.

[71] As reflected in the TMTP calculation for UK insurers, Solvency I is not market-consistent as it does not include an allowance for the cost of holding solvency capital, which an arm's length transaction would be expected to reflect.

[72] There are rare circumstances in which the use of the Matching Adjustment could increase Technical Provisions.

adverse impact on Own Funds and therefore a lower spread risk capital requirement than would be held in the absence of the Matching Adjustment.

8.14 Insurers with approval to use the Matching Adjustment are required to disclose the impact it has on their Solvency II financial positions. As at 31 December 2020:

- The Solvency II financial position of the PAC Shareholder-Backed Business benefited from the Matching Adjustment by £4.9 billion, of which £2.2 billion related to the impact on its Own Funds and £2.7 billion related to the impact on its SCR. PAC estimates that, in the event that the Matching Adjustment were set to zero, the SCR Coverage Ratio of the PAC Shareholder-Backed Business would be approximately 83% at 31 December 2020. These figures, including the 83% SCR Coverage Ratio, do not take account of PAC's ability to seek a recalculation of its TMTP in the event that the Matching Adjustment were set to zero. Such a recalculation would be subject to regulatory approval. PAC does not have details of the expected financial impact of such a recalculation but, if approved, a TMTP recalculation would be likely to partially mitigate the solvency impact of a zero Matching Adjustment.
- Rothesay's Solvency II financial position benefited from the Matching Adjustment by £14.1 billion, of which £7.5 billion related to the impact on Rothesay's Own Funds and £6.6 billion related to the impact on Rothesay's SCR. Rothesay estimates that, in the event that the Matching Adjustment were set to zero, its SCR Coverage Ratio would reduce to 41% as at 31 December 2020. The 41% figure for Rothesay is not directly comparable with the 83% figure quoted above for PAC, as it assumes that Rothesay would receive approval from the PRA for a TMTP recalculation in such a scenario. Rothesay estimates it would have an MCR Coverage Ratio[73] of 133% in this scenario (after the assumed TMTP recalculation).

8.15 The analysis in paragraph 8.14 shows that the relative benefit of the Matching Adjustment to Rothesay is significantly greater than it is to PAC. However, it should be noted that:

- The Transferring Business is reinsured to Rothesay and Rothesay makes use of the Matching Adjustment in determining its liabilities and capital requirements for the reinsured Transferring Business. By contrast, PAC does not apply the Matching Adjustment to the liabilities reinsured to Rothesay as there is no material solvency benefit to doing so for liabilities that are fully reinsured, but there is nevertheless an indirect impact on PAC (not captured in the figures quoted in paragraph 8.14) through Rothesay's use of the Matching Adjustment. In particular, it is reasonable to assume that the premium paid by PAC to Rothesay at the inception of the Reinsurance Agreement would have been higher if Rothesay had not been able to benefit from the use of the Matching Adjustment on the reinsured business. Moreover, if the reinsured business were to be recaptured by PAC for any reason, it would be likely to seek approval for the use of the Matching Adjustment on the recaptured business, which would increase significantly the benefit it achieves from the Matching Adjustment (and indeed the Transferring Business was subject to the Matching Adjustment within PAC prior to the Reinsurance Agreement being put in place).
- While the impact of the loss of the Matching Adjustment would be highly material to both Rothesay and PAC, as shown in paragraph 8.14, in such a scenario it is likely that both Companies would change their approaches to capital management and take action to improve their solvency positions, for example by reinvesting some of the assets that currently contribute to the Matching Adjustment benefit into assets that attract lower capital requirements in the absence of the Matching Adjustment. Therefore, the effects of losing the Matching Adjustment quoted in paragraph 8.14 are likely to overstate the reduction in SCR coverage that would occur in practice.

8.16 Owing to its strategy of acquiring new blocks of annuity and defined benefit pension business, the absolute impact of using the Matching Adjustment for Rothesay is likely to increase over time (in line with the increase in the size of its balance sheet), whereas for PAC the absolute impact of using the Matching Adjustment is likely to reduce unless PAC

[73] The ratio of A and B, where A = Own Funds eligible to meet the MCR, and B = MCR.

elects to re-enter the market for bulk or retail annuities; this is because PAC's in-payment annuity portfolio is in run-off, and therefore the size of the annuity portfolio to which the Matching Adjustment applies will reduce over time.

Appropriateness of the Matching Adjustment

8.17 Because they do not regard it as fully market-consistent, some commentators have challenged the appropriateness of the Matching Adjustment. They argue that any investment return in excess of risk-free rates should be recognised as it is received, rather than anticipating it by reflecting it in the rate at which liabilities are discounted and thereby creating what they regard as artificial Own Funds.

8.18 In my view, the concept of discounting illiquid liabilities (such as in-payment annuities) at a discount rate that reflects the higher risk-adjusted yields available on illiquid assets used to back such liabilities is sound. In particular, annuity outgo is relatively predictable and there is therefore a low likelihood that a material proportion of the assets backing them would need to be sold in order to meet unexpected outgo. It is therefore reasonable to assume that the part of the excess yield on an illiquid asset which compensates the holder for the risk that the asset needs to be sold quickly and at a discount to its theoretical value will be earned with relative certainty by annuity providers, as they are not materially exposed to that risk. The main difficulty is in ascertaining with any certainty how the excess yield on the asset is broken down into compensation for the asset's illiquidity and compensation for the actual or perceived risk of default of the asset. Therefore, the soundness of the concept behind the Matching Adjustment is subject to ensuring that, in determining the risk-adjusted yield on the asset, an appropriate adjustment has been made to ensure that the discount rate excludes the part of the asset yield representing the risk of default and downgrade. Not to do so would, in effect, result in annuity providers taking advance credit for an asset yield that they do not expect to receive.

8.19 In my view, the Matching Adjustment (as currently formulated) is appropriately calibrated in most circumstances. However, the way in which the Fundamental Spread (see paragraph 4.29) is derived means that it can be insensitive to sudden changes in economic conditions and credit outlook. Therefore, in times of financial market volatility when asset spreads increase significantly over short timeframes without immediate defaults or downgrades, the Fundamental Spread does not always increase to reflect any perceived deterioration in credit outlook, meaning that the benefit available from the Matching Adjustment in such circumstances is sometimes greater than can confidently be justified.

8.20 Looking at the Matching Adjustment through another lens, the prices at which pension scheme buyouts and buy-ins are undertaken with insurers are in many cases low enough that they require the insurer to earn in excess of risk-free returns in order to meet the annuity outgo. Similarly, retail annuities issued to individuals are often priced assuming the insurer can earn in excess of the risk-free yield on its investments. Therefore, a discount rate in excess of the risk-free rate is consistent with the pricing of most arms-length annuity transactions and therefore is arguably aligned with the underlying "market-consistency" principle of Solvency II.

8.21 Whatever the arguments for and against its use, the Matching Adjustment is permitted under the Solvency II regulations (which still apply to UK insurers under UK law) and the PRA has granted approval for its use to a significant number of UK life insurers. While it is possible that the rules governing the Matching Adjustment may change for UK insurers, it is in my view unlikely that the Matching Adjustment will be discontinued or its benefits very significantly constrained. For example, in a speech on 16 March 2021, the Chief Executive of the PRA stated that:

"The principle of the MA – that long-term investors that match assets closely to their long-term liabilities are exposed to fewer risks – is sound."

8.22 He went on to say:

"And its calibration is subject to uncertainty which, combined with its size and the quantity and importance of the services that it underpins – retirement income and long-term investments – mean that we have to maintain a very high confidence that its calibration is suitably prudent."

and

"..we should be cautious about calls for the MA to be made any more generous".

8.23 In my view, these statements indicate that the Matching Adjustment is likely to remain available to insurers over the long term under a UK-specific regulatory framework, albeit that some changes may be made to its design and calibration to ensure it remains suitable; such changes may have the effect of reducing the available Matching Adjustment benefit for some insurers in certain economic conditions, but in my view the essence of the Matching Adjustment is likely to remain, i.e. annuity providers will remain able to reflect risk-adjusted returns on the assets they hold in the regulatory discount rate to a significant degree. While it is possible that changes will be made to the UK regulations relating to the Matching Adjustment that significantly reduce the benefit available to UK annuity providers, I would not expect such changes to be introduced in a way that had a material adverse effect on the security of in-force business.

8.24 In view of this, and given that:

- The concept of the Matching Adjustment is, in my view, generally sound for the reasons set out in paragraphs 8.18 to 8.20;
- Both PAC and Rothesay make significant use of, and benefit significantly from, the Matching Adjustment and, as described above, the Transferring Policies were subject to the Matching Adjustment within PAC prior to the execution of the Reinsurance Agreement;
- The Transferring Policies are reinsured to Rothesay and therefore PAC is already to some degree dependent on Rothesay's financial position which, as described above, makes use of the Matching Adjustment;
- Rothesay holds significant capital under its PIM against the risks associated with the default and downgrade of all of its investments, including those held in its Matching Adjustment Portfolio; and
- Insurers' use of the Matching Adjustment is subject to approval and ongoing oversight by the PRA,

I am satisfied that Rothesay's use of the Matching Adjustment will not have a material adverse effect on the security of benefits under the Transferring Policies.

The Companies' use of the TMTP

8.25 In addition to their use of the Matching Adjustment, both PAC and Rothesay have approval to use the TMTP (see paragraph 4.35).

8.26 Insurers with approval to use the TMTP are required to disclose the impact it has on their Solvency II financial positions. As at 31 December 2020:

- PAC's Solvency II financial position benefited from the TMTP by £1.5 billion, of which £1.2 billion related to the impact of the TMTP on PAC's Own Funds and £0.2 billion[74] related to the impact on PAC's SCR[75].
- Rothesay's Solvency II financial position benefited from the TMTP by £1.6 billion, of which £1.3 billion related to the impact of the TMTP on Rothesay's Own Funds and £0.3 billion related to the impact on Rothesay's SCR.

8.27 The implementation of the Scheme is not expected to lead to a recalculation of the TMTP of either of the Companies as it will only have a small impact on their Solvency II financial positions (which reflect that the risk and benefits in respect of the Transferring Business have already, in effect, been transferred to Rothesay through the Reinsurance Agreement).

8.28 The benefit insurers achieve from the TMTP is, by design, reducing over the period from 1 January 2016 to 31 December 2031 (see paragraph 4.39), and so the benefit of this adjustment to Rothesay's solvency position will gradually reduce. Moreover, I note that:

[74] The sum of the two impacts does not equal the total due to rounding.

[75] While the TMTP principally results in an increase in Own Funds, there is often a smaller impact on the insurer's SCR relating to the effect of the TMTP on deferred tax assets and liabilities.

- PAC's solvency position also benefits from the use of the TMTP to a similar extent to Rothesay, as measured by the impact of the TMTP on Own Funds and SCR; and
- Even if the TMTP were set to zero, Rothesay's SCR Coverage Ratio at 31 December 2020 would be 154%, which is above the upper end of the range provided for in its capital management policy.

8.29 For these reasons, I am satisfied that Rothesay's use of the TMTP will not have a material adverse effect on the security of benefits under the Transferring Policies.

Differences in the approach to the SCR

8.30 For the calculation of the SCR, PAC has approval from the PRA to use its internal model. For its SCR, Rothesay uses a combination of its PIM and the Solvency II Standard Formula, together with a capital add-on in excess of the requirements of the Standard Formula, which has been reviewed and approved by the PRA.

8.31 Under the Solvency II regulations, an internal model has to be calibrated such that the SCR provides a probability of at least 99.5% of remaining able to cover Technical Provisions over a one year time horizon, and the calibration of the Standard Formula targets the same confidence level.

8.32 Although the approaches to calculating Technical Provisions and the SCR differ in some respects between PAC and Rothesay, both approaches are in line with the Solvency II regulations and in both cases the SCR is intended to be sufficient to cover any losses which might arise over a one year period with a probability of 99.5%. In addition, Rothesay has identified risks to which it is exposed that are not adequately covered by the Standard Formula, and is holding a capital add-on in relation to those risks, as described in paragraph 6.30.

8.33 Moreover, all insurers subject to the Standard Formula, including Rothesay, are required to conduct an annual assessment of the continuing overall appropriateness of the Standard Formula for their business, which is shared with the PRA.

8.34 Taking this into account, I am satisfied that any differences in the approaches to the SCR calculation between PAC and Rothesay will not have a material adverse impact on the security of benefits of the Transferring Policies.

8.35 As described in paragraph 6.31, Rothesay is currently developing a full internal model that, once approved by the PRA, will be used to determine all components of its SCR. This internal model remains in its development stage and I understand that the internal model will not be implemented prior to the Transfer Date. Given this, I have not commented on the potential implications of this internal model for Rothesay's Solvency II financial position, but I note that the internal model will be subject to a rigorous approval process by the PRA, which will apply the same standards to Rothesay's internal model design, calibration and governance as will have been applied to PAC's internal model. I am therefore satisfied that any change to Rothesay's Solvency II financial position as a result of the internal model will not affect my conclusions in relation to the Scheme.

Comparison of pre- and post-Scheme financial strength available to support the Transferring Business

8.36 Table 8.1 below shows the pre-Scheme financial strength of PAC and the pro forma post-Scheme financial strength of Rothesay as at 31 December 2020 on the Solvency II Pillar 1 basis. This shows a comparison of the Solvency II financial position that currently provides security for guaranteed benefits for Transferring Policies (i.e. PAC's pre-Scheme financial position) with the one that will provide such security after the transfer (i.e. Rothesay's post-Scheme financial position).

TABLE 8.1: COMPARISON OF SOLVENCY II FINANCIAL POSITIONS OF PAC (PRE-SCHEME) AND ROTHESAY (POST-SCHEME) AT 31 DECEMBER 2020

31 December 2020			
£m	PAC (Consolidated Basis), pre-Scheme	PAC Shareholder-Backed Business, pre-Scheme	Rothesay post-Scheme
Total Assets (net of other items)	186,174	59,704	61,742
Technical Provisions (including TMTP)	172,561	50,987	54,389
Own Funds (A)	**13,613**	**8,718**	**7,353**
SCR (B)	10,002	5,107	3,623
Excess Capital (=A-B)	3,611	3,611	3,730
SCR Coverage Ratio (A/B)	***136%***	***171%***	***203%***

8.37 Table 8.1 shows that, on the Solvency II Pillar 1 basis, if the Scheme had been implemented on 31 December 2020, the capital resources of Rothesay would have covered its SCR with a ratio of 203%.

8.38 This represents a material increase in SCR Coverage Ratio relative to the PAC pre-Scheme SCR Coverage Ratios of 136% and 171% at 31 December 2020, on both a consolidated basis and based on the position of the PAC Shareholder-Backed Business. That said, it is important to recognise that:

- Post-Scheme, Rothesay's SCR Coverage Ratio would be significantly in excess of its target range of 130% to 150%, and therefore Rothesay is free to remit these excess capital resources to its shareholders or otherwise deploy them, for example in financing new business; and
- PAC's current level of SCR coverage is also in excess of its target level. PAC's SRA Framework states that PAC's Board will decide whether to return surplus capital above the internal capital target to its shareholder as a dividend.

8.39 In addition, PAC's management has informed me that approximately £1.0 billion of capital resources invested in liquid assets were available at the M&G plc level as at 31 December 2020, although M&G plc would be under no legal obligation to make such assets available to PAC if PAC were to get into difficulty beyond any contractual amounts agreed in relevant support arrangements.

8.40 However, in the event that these assets had been made fully available to the PAC Shareholder-Backed Business on that date, the SCR Coverage Ratio of the PAC Shareholder-Backed Business would have increased to approximately 191% (from 171%) and that of PAC's consolidated regulatory position would have increased to approximately 146% (from 136%), which would still have left PAC with a lower SCR Coverage Ratio than Rothesay at 31 December 2020. Moreover, it is important to note that:

- M&G plc is under no legal obligation to provide capital support to PAC if it gets into difficulty beyond any contractual amounts agreed in relevant support arrangements[76].
- In a situation in which PAC requires capital support, there is a heightened probability of calls on capital resources at the M&G plc level from other subsidiaries within the M&G Group, for example from the other material insurance entities within the M&G Group (PIA and PPL) or from the asset management business within the M&G Group; and
- The liquid assets held at the M&G plc level are also needed to meet central costs, interest costs on debt, and dividends to shareholders.

[76] As described in paragraph 5.64 I have been provided with details of arrangements formalising the circumstances in which M&G plc would make capital support available to PAC, but these are confidential and I am not permitted to disclose them.

8.41 Based on the analyses above, I am satisfied that the differences in financial strength set out above will not lead to a material adverse impact on the security of benefits of the Transferring Policies, even after the wider capital resources of the M&G Group are taken into consideration.

Quality of Own Funds

8.42 As at 31 December 2020, 100% of PAC's Own Funds were Tier 1 capital. Approximately 80% of Rothesay's Own Funds were Tier 1, 13% were Tier 2 and 7% were Tier 3 at the same date. Rothesay's Tier 2 and Tier 3 Own Funds are all provided through the issue of debt instruments. As described in paragraph 6.37, the repayment of these creditors ranks, in effect, below policyholder liabilities in the event of insolvency and therefore, from a policyholder security perspective, the debt could not, in this scenario, be repaid before all policyholder liabilities had been met.

8.43 Furthermore, under the rules of Solvency II, a company must cover at least 50% of its SCR with Tier 1 capital. As at 31 December 2020, 100% of PAC's SCR was covered by Tier 1 Capital and 100% of Rothesay's SCR was covered by Tier 1 capital; therefore both companies were significantly in excess of the minimum regulatory requirements.

8.44 Taking this into account, I am satisfied that the differences in the composition of the Own Funds of PAC and Rothesay set out above will not have a material adverse impact on the security of benefits of the Transferring Policies.

The security provided by the custody accounts

8.45 As described above, as part of the Reinsurance Agreement, custody accounts were established to hold the assets posted as collateral in relation to this arrangement. These accounts are intended to provide security to PAC by allowing PAC to take control of the assets in the custody accounts in the event that Rothesay fails to honour its obligations under the Reinsurance Agreement. In this scenario, the Transferring Policyholders would not have any preferential claim on any of these assets; they would be available to support all of PAC's business.

8.46 Following the implementation of the Scheme, the security arrangements over the assets will be released, with the exception of the security arrangements required to facilitate the continuing reinsurance of the Non-Transferring Reinsured Policies and any Excluded Policies. The Transferring Policies, as direct policies of Rothesay, will have security provided by the assets in Rothesay (as will all other policies of Rothesay), including those currently held in the custody accounts which will be released to Rothesay after the implementation of the Scheme.

8.47 The custody accounts currently play an important part in reducing PAC's counterparty exposure to Rothesay; if Rothesay were to become insolvent, PAC would rank behind directly written policies in terms of creditor priority upon wind-up. The purpose of the custody accounts is to ensure that the assets they hold would be available to meet the liabilities of the Reinsured Business if Rothesay were to become insolvent. After the proposed transfer, the Transferring Policies will be direct policies of Rothesay and therefore will rank equally with Rothesay's other policies. As described in paragraph 8.46 above, custody assets will continue to be required to support the security arrangements for the continued reinsurance of Non-Transferring Reinsured Policies, but the amount of such assets will be greatly reduced.

8.48 Following the implementation of the Scheme, the eligibility criteria and rules for the management of the collateral under the Reinsurance Agreement (and related security deeds) will also fall away, except for assets required to support the continued reinsurance of Non-Transferring Reinsured Policies. This means that the assets available to support the Transferring Business may be invested in a wider range of asset classes than is the case while the assets are held in the custody accounts.

8.49 However:

- Rothesay has informed me that it does not have specific plans to invest the assets released from the custody accounts in a way that results in a materially different asset composition or risk profile, other than in ways that would currently be permitted within the custody accounts, for example, to ensure assets and liabilities remain closely matched. That said, it is likely that, over time, the assets released from the custody accounts would be pooled with Rothesay's wider asset portfolio and aligned with its overall investment strategy.

- The purpose of the custody accounts is to ensure that the assets within the accounts are available to PAC in the event of a default by Rothesay, and therefore the desired characteristics of custody account assets may be different from the desired characteristics of assets held by Rothesay outside its custody accounts. For example, it is likely to be desirable that custody account assets are relatively liquid and have an objective, observable market price, whereas for other long-term investments of Rothesay such characteristics may be less relevant. It may therefore be reasonable and within Rothesay's risk appetite to eventually alter the mix of the assets released from the custody accounts;
- The assets held will be subject to the Solvency II requirements relating to investments, including the Prudent Person Principle[77];
- To the extent that Rothesay does choose to alter the mix of assets released from the custody accounts, the Solvency II regulations will require Rothesay to hold capital against the risks in its investment portfolio, and therefore any increase (or decrease) to the riskiness of the asset mix will, all else being equal, result in higher (or lower) capital requirements to continue to provide an appropriate level of policyholder benefit security; and
- to the extent that the assets are held in Rothesay's Matching Adjustment Portfolio, any asset classes held within the Matching Adjustment Portfolio will need to have been subject to approval by the PRA as regards their suitability for such a purpose.

8.50 Taking this into account, I am satisfied that the release of the custody assets and the associated changes to the custody arrangements will not have a material effect on the security of benefits for the Transferring Policies.

Other sources of financial strength

8.51 PAC's use of reinsurance, and in particular the Reinsurance Agreement with Rothesay, means that PAC policyholders (both Transferring Policyholders and non-transferring policyholders of PAC) benefit indirectly from the strength of the balance sheet of the respective reinsurers as well as from the balance sheet of PAC. This is because the reinsurers are required to meet their obligations to reimburse PAC for the claim outgo of policies covered by the respective reinsurance treaties, even if meeting these obligations requires the reinsurers to use up their capital resources. Furthermore, in the event that the reinsurers are unable to meet their obligations to PAC, PAC remains obliged to meet its obligations to its policyholders.

8.52 After the transfer, the Transferring Policyholders will become direct policyholders of Rothesay and the Reinsurance Agreement will be amended to exclude the Transferring Policies from its scope. This means that the Transferring Policies will rely upon the financial strength of Rothesay but will no longer have recourse to the financial strength of PAC. At first sight, it could therefore appear that Transferring Policyholders have in some way lost a source of security.

8.53 However, I do not believe that this argument implies a material reduction in security for Transferring Policyholders for the following reasons:

- The Reinsurance Agreement is an asset of PAC, the value of which is supported by the financial strength of Rothesay. However, PAC could equally have elected to back the liabilities associated with the Transferring Business with different assets, for example a portfolio of government or highly rated corporate bonds. Had PAC chosen to do this, the contractual cash flows payable to PAC under the bond assets within this portfolio would all be supported by the balance sheets of the respective bond issuers (including, in the case of UK government debt, that of the UK Government), and the issuers would be required to exhaust their capital resources if necessary to meet their contractual commitments under the bonds, in the same way that Rothesay is required to do under the Reinsurance Agreement.

[77] The Solvency II rules include the Prudent Person Principle which imposes certain qualitative requirements around investments of insurance companies, including that "…insurance and reinsurance undertakings shall only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report.", and assets "…shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole."

- Under Solvency II, the amount of capital that an insurance company is required to hold is directly related to the risks to which it is exposed, including the level of security associated with the assets that it holds. PAC benefited from a significant reduction in its required capital when the Reinsurance Agreement was put in place, effectively offsetting the protection from the additional capital that Rothesay was required to hold.

- Although the Reinsurance Agreement is different from an investment in bonds because it also passes on insurance risks to Rothesay (for example, longevity risk on the reinsured business), this difference in risk exposures is also reflected in PAC's capital requirements.

8.54 Moreover the assets used by insurers to back their liabilities (whether they are reinsurance assets or other categories of asset) are a matter for the insurer and, in my view, policyholders do not have a reasonable expectation as to the specific asset classes in which their insurer invests, other than that the insurer's investments (and any associated capital requirements) should meet the requirements of the relevant regulations (including the Prudent Person Principle) and provide a high level of security for policyholder benefits.

Resilience of the Solvency II financial positions of PAC and Rothesay

8.55 The financial positions of PAC and Rothesay shown in Table 8.1 show that both PAC and Rothesay have significant capital resources in excess of the regulatory minimum. This means that their respective abilities to meet their Technical Provisions are resilient to all but the most severe adverse scenarios. However, the financial positions in Table 8.1 do not give full information on how resilient the Companies' abilities to continue to meet their respective SCRs are against:

- Actions planned to be taken over the short to medium term in line with the Companies' respective business plans, for example planned new business volumes; and

- Adverse scenarios over the short to medium term once the impact of the Companies' business plans are taken into account.

8.56 Both Rothesay and PAC have shared with me the results of their respective scenario analyses from their ORSA exercises under which they seek to estimate the impact on their respective future medium-term solvency positions of a number of adverse scenarios. In Rothesay's case the base financial position is as at 31 December 2020, whereas in PAC's case it is 31 December 2019. These analyses focus on the key risk exposures to both companies and the impact on their medium-term solvency position should these risks materialise. The scenario analysis generally assumes in most cases that PAC and Rothesay continue to execute their respective business plans, and therefore in Rothesay's case they include scenarios in which Rothesay continues to write substantial volumes of new business.

8.57 Additionally, PAC and Rothesay have published some point-in-time sensitivity analysis of their respective solvency positions in their publicly available Solvency and Financial Condition Reports ("**SFCR**") as at 31 December 2020.

8.58 The details and results of the ORSA scenario and sensitivity analyses are confidential and I am not permitted to disclose them. They are also unaudited, and I have not conducted a review of the accuracy of the underlying financial modelling. However, PAC and Rothesay have provided me with details of their respective internal processes for review, validation and sign-off of the financial modelling and, based on this, I am satisfied that it is appropriate for me to rely on the modelling without further independent analysis.

8.59 From the perspective of Transferring Policyholders, the results I have received from Rothesay show that, under what appear to be relatively severe and persistent stress scenarios, Rothesay's solvency position is expected to be resilient over the medium term and in particular is not expected to fall below the minimum level required by the Rothesay capital management policy.

8.60 It should be noted that the nature of the stress scenarios considered by PAC and Rothesay in their respective analyses are different given their differing business models and risk exposures. This is to be expected, but there is consequently no real scope to use this analysis to assess the relative resilience of PAC and Rothesay to adverse scenarios.

8.61 In accordance with common market practice regarding scenario analysis, PAC and Rothesay have not carried out any scenario analysis which considers the impact of adverse scenarios over the long term, i.e. beyond their respective business planning periods[78] (three years for PAC and four years for Rothesay). This is because any such scenario analysis would be subject to significant uncertainty over such time periods that would materially limit its usefulness; for example, it is not clear what assumptions should be made around economic conditions, new business volumes or new business margins beyond the business planning period, and it may not be reasonable to assume that the markets for new business in which PAC and Rothesay operate would remain in their current form over a longer-term time horizon.

8.62 It should be noted that PAC's ORSA scenario analysis is based on its financial position at 31 December 2019 but, as described above, PAC has produced point-in-time sensitivity analysis on its solvency position as at 31 December 2020. Also, from the perspective of the Transferring Policyholders, it is Rothesay's financial resilience that is of particular interest and, in this regard, I have access to scenario and sensitivity analysis that is based on Rothesay's financial position as at 31 December 2020. Moreover, the PAC Shareholder-Backed Business is relatively stable, and I would not expect the impact of financial stress scenarios on PAC to differ materially from year to year; therefore I am comfortable relying on PAC's 31 December 2019 ORSA analysis.

8.63 Rothesay's publicly disclosed sensitivity analysis from its SFCR shows that the most adverse sensitivity tested is a 1 percentage point fall in interest rates, which would have resulted in a 35 percentage point fall in Rothesay's solvency ratio at 31 December 2020. By contrast, a 0.5 percentage point fall in interest rates would, according to PAC's SFCR, have resulted in a fall in the solvency ratio of the PAC Shareholder-Backed Business of 11 percentage points at 31 December 2020. This shows that Rothesay's solvency ratio is potentially more sensitive to changes in interest rates than PAC's under the assumptions used in deriving the sensitivities, albeit that a relatively severe scenario such as an instantaneous 1 percentage point fall in interest rates would not result in Rothesay's solvency ratio falling below the upper end of the target range from its capital management policy.

8.64 However, Rothesay's sensitivity to interest rates can in part be explained by its approach to hedging interest rate risk, under which it does not seek to closely hedge its solvency position against interest rate falls when its solvency position is strong. Had Rothesay's solvency position been significantly weaker, then (consistent with one of the available actions set out in its capital management policy) it could have elected to undertake more intensive hedging of its solvency position (albeit that this would have come at a higher cost) which would have significantly reduced the sensitivity of its solvency position to interest rate falls. In my view, such hedging activity is a credible management action available to Rothesay.

8.65 To the extent that they are publicly disclosed in their respective SFCRs, both PAC's and Rothesay's sensitivity to other risk factors (as measured by impact on solvency ratio) are relatively modest for the risk factors that they have in common.

8.66 In conclusion, while it is speculative to measure risks to solvency to both PAC and Rothesay over the long periods for which annuities are paid, I am satisfied that:

- Rothesay would remain able to meet the requirements of its capital management buffer under relatively severe and persistent adverse scenarios over the medium term; and
- Based on the position at 31 December 2020, the resources currently potentially available to PAC at the M&G plc level (including the resources in excess of those contractually pledged to PAC under parental capital support arrangements) would not be sufficient to increase PAC's financial strength beyond that of Rothesay.

The PAC and Rothesay capital management policies and risk appetite statements

8.67 The capital management policy of an insurer sets out the level of capital that the insurer aims to hold, how it manages its business to that target and the actions it would expect to take if its capital resources were out of line with that target.

[78] I note that, while it is not common practice for insurers to undertake general scenario analysis over periods that exceed their business planning period, there are specific instances in which insurers may undertake scenario analysis over longer periods, for example projections showing the impact of the run-off of the TMTP or projections showing the run-off profile of a with-profits fund. Such analysis would typically analyse the projected solvency of the insurer assuming no new business is written or, in the case of the TMTP run-off, would focus principally on business written before 1 January 2016. By contrast, the ORSA scenario analysis includes the projected impact of continued new business.

Target capital is typically expressed in terms of regulatory capital requirements. The regulatory capital requirements may target a specified probability of remaining solvent over a certain time horizon: for example, for Solvency II it is a 99.5% probability of remaining able to meet Technical Provisions over one year. By committing additional capital to be held on top of the regulatory requirements, the capital management policy increases the probability of remaining solvent over a particular timeframe and therefore increases the security of the benefits of business that is subject to the capital management policy.

8.68 Capital management policies also typically provide triggers for, and descriptions of, actions by the insurer's management aimed at reducing the likelihood of a breach of regulatory capital requirements and subsequent regulatory intervention.

8.69 When considering the capital resources available to provide security for policy benefits, greater reliance can be placed upon capital resources held up to the level required by the capital management policy than on capital resources in excess of this level, since assets in the latter category are potentially available for distribution to shareholders (subject to the relevant rules on dividend payments) or for investment in other business ventures. Therefore, the relative strength of the capital management policies of PAC and Rothesay is relevant in considering the security of benefits of the Transferring Business, as is the governance that would apply to changes made to those policies.

8.70 Currently, the security of the benefits under the Transferring Policies is provided by the assets of PAC (including the value of amounts recoverable from Rothesay through the operation of the Reinsurance Agreement) held in accordance with the PAC SRA Framework as described in Section 5. Following the implementation of the Scheme, the Transferring Business will be transferred into Rothesay and security for the benefits of the Transferring Policies will subsequently be provided by the assets of Rothesay held in accordance with the Rothesay capital management policy as described in Section 6.

8.71 PAC and Rothesay have both informed me that they do not expect to make any changes to their risk appetite or capital management policies as a result of the proposed transfer, although both Companies are free to change their risk appetite or capital management policies for other reasons in the future, subject to the governance processes described in paragraph 4.51.

The relative strengths of the capital management policies

8.72 PAC's SRA Framework includes a target SCR Coverage Ratio and, in addition, outlines a series of threshold levels for its SCR Coverage Ratio (the "**solvency intervention ladder**"), each with associated actions aimed at protecting the company's solvency, with the actions becoming more severe as the coverage ratio reduces. As noted in paragraphs 5.53 and 5.57 respectively, the thresholds are reviewed regularly and are confidential.

8.73 Rothesay's capital management policy includes a target operating range of SCR Coverage Ratio of 130% to 150%. As shown in Table 8.1, Rothesay's actual SCR Coverage Ratio was 203% at 31 December 2020, i.e. significantly in excess of its target operating range.

8.74 In contrast to Rothesay's approach to maintaining a target range for its SCR Coverage Ratio, PAC's target minimum SCR Coverage Ratio for the PAC Shareholder-Backed Business is a specific level (rather than a range). PAC chooses not to disclose details of its SRA Framework publicly and I am not permitted to give specifics of the SRA Framework in this Report. This means that I am unable to give full details of how the structure and parameterisation of PAC's SRA Framework compares to Rothesay's capital management policy, although I am permitted to disclose that PAC's target minimum SCR Coverage Ratio falls within the 130% to 150% target range provided for by Rothesay.

8.75 Because Rothesay targets an SCR coverage ratio within a range, it could be operating within this range but have an SCR Coverage Ratio which is either below or above PAC's target minimum SCR Coverage Ratio. For the reason given in paragraph 8.81 below, operating at the same SCR Coverage Ratio does not necessarily imply the same level of protection.

8.76 Many UK insurers carry out analysis that estimates the level of resilience against insolvency that is provided by their capital management policy. Rothesay's capital management policy states that a SCR Coverage Ratio of 130%

represents a “99.96% confidence level”. This means that Rothesay estimates that, if its SCR Coverage Ratio were exactly 130%, the likelihood of its assets being sufficient to cover its Technical Provisions in one year’s time is 99.96%, i.e. a 0.04% (1-in-2,500) likelihood of being unable to cover its Technical Provisions in full in one year’s time.

8.77 This 99.96% confidence level assumes that Rothesay would not take any mitigating actions in a scenario in which its solvency level started to deteriorate. In fact, Rothesay has a number of credible actions available to it in such a scenario, any one of which would increase the 99.96% likelihood of remaining solvent.

8.78 Rothesay’s 99.96% confidence level compares to the one year confidence level that is intended to be represented by the SCR under Solvency II, which is 99.5%. In other words, the additional 30% minimum “buffer” provided for by Rothesay’s capital management policy increases the likelihood of remaining able to meet Technical Provisions over one year from 99.5% to 99.96%.

8.79 It is also important to note that the 130% SCR Coverage Ratio is the minimum of Rothesay’s target operating range and that Rothesay’s capital management policy provides for a target operating range of 130% to 150% SCR coverage, which therefore means that a 99.96% likelihood of meeting its Technical Provisions is the minimum level of protection that Rothesay’s capital management policy targets; 150% solvency coverage is expected to result in a 99.994% likelihood that Rothesay is able to cover its Technical Provisions in a year’s time (or a likelihood of approximately 1-in-17,000 of that condition not being met). Furthermore, Rothesay’s actual capital coverage ratio has been significantly in excess of 150% at each year-end since Solvency II came into force.

8.80 Although PAC appears to target a slightly higher SCR Coverage Ratio than Rothesay’s minimum coverage ratio of 130%, a direct comparison would be imperfect given that PAC and Rothesay use different approaches to calculating their SCR (as discussed in paragraphs 8.30 to 8.34), although both approaches target the required 99.5% confidence level.

8.81 The difficulty in comparing PAC’s capital management policy to that of Rothesay arises because simply comparing the level of SCR Coverage Ratio that each firm targets does not take into account the volatility of the SCR Coverage Ratio as conditions change. The strength of the capital levels targeted by each company can instead be assessed by estimating how often they are likely to be breached. However, complexity arises when comparing the likelihood of PAC’s capital levels of being breached to Rothesay’s because while Rothesay estimates the implied likelihood of being unable to meet its Technical Provisions over one year, PAC estimates the likelihood of being unable to cover the Technical Provisions and 100% of the SCR for the PAC Shareholder-Backed Business over one year.

8.82 Therefore, because the two companies calibrate their respective capital management policies differently, their confidence levels (i.e. the likelihoods described in paragraph 8.81) cannot be compared directly as they are referring to the likelihood of events of very different severity.

8.83 I understand that neither Rothesay nor PAC is in a position to carry out detailed analysis that produces a direct and reliable comparison between the two confidence levels, due to the level of complexity involved in such an analysis.

8.84 Nevertheless, although (as described in paragraph 8.81) Rothesay typically calibrates its minimum SCR Coverage Ratio in terms of the likelihood of being unable to meet its Technical Provisions over one year, Rothesay has provided me with a rough estimate of how the lower and upper end of its target range of 130% to 150% relates to the likelihood of being unable to cover its Technical Provisions and 100% of its SCR (rather than just its Technical Provisions) over one year (i.e. a metric comparable to PAC’s metric). This estimate implies that Rothesay’s minimum coverage ratio of 130% corresponds to a higher likelihood of breaching the SCR over a one year period than PAC’s target minimum SCR Coverage Ratio, whereas the upper end of its target range of 150% corresponds to a lower likelihood of breaching the SCR over a one year period than PAC’s target minimum SCR Coverage Ratio. However, Rothesay’s estimate is not the basis on which it manages its capital (which is described in paragraph 8.76) and was based on simplified assumptions that may not be borne out in practice. In my view this information should not be given undue weight when comparing the level of protection that Rothesay’s and PAC’s capital management policies provide.

8.85 In addition, it is important to note that what may appear a material difference in SCR Coverage Ratio may not equate to a material difference in the likelihood of insolvency. For example:

- If Rothesay held 100% of its SCR, the likelihood of its assets being sufficient to cover its Technical Provisions in one year's time is intended to be 99.50%;
- If Rothesay held 130% of its SCR, the likelihood of its assets being sufficient to cover its Technical Provisions in one year's time is estimated to be 99.96%; and
- If Rothesay held 150% of its SCR, the likelihood of its assets being sufficient to cover its Technical Provisions in one year's time is estimated to be 99.994%.

8.86 Therefore, although moving from an SCR Coverage Ratio of 150% to 130% may appear significant, the 20 percentage point reduction in SCR Coverage Ratio only decreases the likelihood of being unable to meet its Technical Provisions in a year's time by 0.034 percentage points, and it is important to understand this context when interpreting the relative strengths of individual capital management policies, noting that estimates such as those shown in paragraph 8.85 are subject to considerable uncertainty.

8.87 In summary, PAC's SRA Framework provides a slightly higher level of security for policyholder benefits than the lower end of the target range provided for by Rothesay's capital management policy based on a comparison of headline probabilities, but given that:

- Both Companies' capital management policies provide a very high level of security for policyholders, even without allowing for actions that would be available to alleviate a deterioration in solvency;
- Both Companies actively manage their risk exposures and volatility in their respective SCR Coverage Ratios on a continuous basis, and the capital management policies simply provide a framework within which this management takes place;
- Management actions are available to both PAC and Rothesay to mitigate a deterioration in solvency (as described below), and this reduces even further the likelihood that they will be unable to meet their liabilities; and
- Scenarios which could lead to the entire Own Funds of either of the Companies being dissipated are so extreme that any comparison of probabilities is subject to a very high degree of uncertainty,

I have concluded that the protection provided for by Rothesay's and PAC's capital management policies are broadly comparable.

8.88 I am therefore satisfied that the impact of a change of capital management policy will not have a material adverse effect on the security of benefits under Transferring Policies.

The available responses of management to a breach of the capital management policies and risk appetite

8.89 The financial information shown for PAC and Rothesay indicates that both companies were comfortably solvent at 31 December 2020. Furthermore, both companies' capital resources were more than sufficient to meet the requirements of their respective capital management policies. This means that both companies are resilient to adverse changes in future experience at or beyond the level required by their respective capital management policies:

- In the case of Rothesay, this means that its resilience is such that there is a greater than 99.96% likelihood that its resources will be sufficient to meet its Technical Provisions one year hence, even assuming no mitigating actions were taken in the event of a solvency deterioration. Indeed, as described in paragraph 8.79, Rothesay's SCR Coverage Ratio being in excess of the upper end of its capital management policy range (i.e. greater than 150%) means that this likelihood is in fact likely to be significantly in excess of 99.994%.

- In the case of PAC, the details of the required resilience under the PAC SRA are confidential, but it is expressed as a likelihood of an SCR breach over a one year period, and therefore PAC is resilient beyond the likelihood required by the PAC SRA to the risk of an SCR breach during the next year.

8.90 In accordance with common practice among UK insurers, both PAC and Rothesay express their capital management policies in terms of a minimum level of resilience to adverse changes in conditions during a one year period, consistent with the "one year" approach to the calibration of the SCR[79]. It is therefore difficult to assess with any precision the level of resilience the Companies have to adverse changes in conditions over a longer period. In particular, any quantification would have to recognise the way in which companies manage their capital resources and risk exposures in practice, and also recognise the reality of prudential regulation, under which the intensiveness of regulatory oversight would increase as the solvency of an insurer deteriorated.

8.91 In practice, insurers monitor their solvency positions on a frequent basis, with insurers of the size of PAC and Rothesay carrying out daily solvency monitoring during periods of market volatility or uncertainty (and indeed Rothesay's practice is to carry out daily solvency monitoring at all times), and it is common for the output of this monitoring to be shared with the PRA. Indeed, insurers would have the obligation to inform the PRA of anything that the PRA might reasonably be expected to be told about, which would include a material deterioration in solvency. In practice, in the event of a deterioration in solvency, I would therefore expect the following:

- Owing to the frequency of solvency monitoring, it is very likely that such a deterioration would be detected before it resulted in a breach of the company's capital management policy, and it is also likely that mitigating actions, consistent with the insurer's internally agreed schedule of available actions, would be taken to avoid a breach of the capital management policy.

- To the extent that these actions do not succeed in avoiding a breach of the capital management policy, it is likely that further mitigating actions would be taken to restore compliance with the policy. Given their size, I would expect firms such as PAC and Rothesay to come under intensive scrutiny from the PRA and to be required to liaise closely with the PRA and develop a plan to rapidly restore compliance with their capital management policies.

- To the extent that solvency levels continued to deteriorate, regulatory oversight would become ever more intensive, and in particular in the event that the insurer were to breach its SCR (i.e. its SCR Coverage Ratio dropped below 100%) I would expect the PRA to require the firm to use any and all actions available to it to restore compliance with the SCR, noting that the PRA has certain powers available to it that allow it to require firms to take (or not to take) certain actions[80].

8.92 Therefore, for large companies such as PAC and Rothesay, deteriorations in solvency are typically detected early and capital management activities would typically take place promptly in response to such deteriorations in order to avoid a breach of the capital management policy.

8.93 Both PAC's SRA Framework and Rothesay's capital management policy outline a range of mandatory and possible actions in response to a breach of their respective risk appetite/capital management policy buffers. However, the actions available to PAC and Rothesay to improve their solvency positions in the event of a breach of their target capital range may be different. In particular, the extent to which reinsurance and other risk-mitigating transactions may be used to improve solvency will depend upon the nature of the risks in the relevant company, the availability of counterparties willing to enter into such transactions to mitigate those risks in the circumstances then prevailing, and the extent to which the company has already mitigated its risk exposures.

8.94 Actions that would currently be available to Rothesay to alleviate a deterioration in its Solvency II financial position are set out in its capital management policy and include:

[79] See paragraph 4.22 for an explanation of the interpretation of the one year calibration.

[80] The PRA's approach to insurance company supervision is set out here: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/insurance-approach-2018.pdf

- **A change to Rothesay's investment mix:**

  The mix of investments held by an insurer and their relative riskiness are taken into account in determining the insurer's SCR, with some asset classes incurring higher contributions to the SCR than others. Therefore, in the event of a deterioration in solvency, Rothesay could rebalance its liquid investments into a more optimal asset mix from a capital perspective.

- **The restriction or cessation of new annuity transactions:**

  For annuity firms such as Rothesay, new transactions normally consume capital at outset, with that capital being recouped as profit emerges over time. Restricting or ceasing new business would therefore reduce or eliminate the associated capital strain. In particular, any emerging profits on in-force business would then contribute to an improvement in the capital position, rather than being used to support the writing of new business.

- **Increased levels of hedging of Rothesay's solvency position:**

  Rothesay already has a derivatives-based hedging programme (similar to that described in paragraph 4.73) in place intended to protect its solvency position in the event that long-term interest rates fall significantly, which is a key risk exposure for insurers with long-term business that provides guarantees (the guaranteed amounts of pension payments in this case), and this programme could be extended to more tightly immunise Rothesay's solvency position. It should be noted that any extension of the hedging programme would be likely to give rise to additional hedging costs, but these would be assessed by Rothesay at the time and factored into any cost-benefit analysis. Additionally, the hedging instruments used by Rothesay are generally traded in large volumes in a liquid market.

- **Increased use of longevity reinsurance:**

  Rothesay already passes on a significant proportion of the longevity risk to which it is exposed on its pension business to external reinsurers; this provides a benefit to Rothesay's solvency position as the premiums it pays to its reinsurers to take on this risk are lower than the reduction in SCR and Risk Margin that results from the reinsurance, reflecting the reduction in its longevity risk exposure. However, there is scope for Rothesay to increase the proportion of its longevity risk that it externally reinsures, which would be of benefit to its solvency position.

- **Making use of the £420 million loan facility available to Rothesay Limited (Rothesay's parent holding company), as described in paragraphs 6.50 and 6.51:**

  This facility could be drawn upon by Rothesay Limited and injected into Rothesay to improve its capital position. This would require the agreement of the Board of Directors of Rothesay Limited, but I consider it unlikely that Rothesay Limited would refuse a reasonable request from Rothesay to draw on the facility.

- **A recalculation of Rothesay's TMTP, subject to the regulatory criteria governing TMTP recalculations being met:**

  It is permitted to recalculate the TMTP in certain circumstances, including a material change in a firm's risk profile. There are therefore scenarios (such a significant fall in long-term interest rates) in which it is likely Rothesay would be in a position to seek regulatory permission to increase its TMTP, which would improve its current regulatory solvency position, albeit that this benefit would reduce over time as the TMTP continues to run off to zero by the end of 2031.

- **A reduction in discretionary expenses:**

  In a situation in which Rothesay's solvency position was threatened, Rothesay could take steps to reduce its expense base. Some of this reduction would be likely to have an immediate impact on its solvency position through lower Technical Provisions, and the remainder of the reduction would flow through as increased surplus (i.e. contributing to an improved solvency position) over time. Some of the expense-reduction actions available to Rothesay would be cost-free, at least in the short term (for example, reducing or eliminating discretionary remuneration), whereas other actions would be likely to result in an initial outlay but would still give rise to a net solvency benefit or increased future solvency surplus emerging (for example, a reduction in employee headcount).

8.95 In addition to the actions set out above, Rothesay's capital management policy provides for the option of seeking additional capital, either from its existing shareholders or from new debt or equity providers. In relation to this potential action:

- Rothesay has on a number of occasions successfully raised new equity and debt capital, albeit to support its business plans rather than to mitigate a solvency issue.
- Given the degree of monitoring and regulatory oversight in relation to solvency, it is likely that any action to seek additional capital to alleviate a deteriorating solvency position would take place at a stage well before an SCR breach occurred and, in the case of existing shareholders, it is likely that it would be in their interest to provide this capital in this situation in order to protect the full value of their investment and retain control of it. In particular, in a scenario in which Rothesay's SCR Coverage Ratio reduced to a level that is close to 100%, Rothesay's shareholders would be presented with a choice. On the one hand, they could choose to invest an amount that is relatively small in comparison to the value of their investment to recapitalise Rothesay up to an acceptable level (e.g. up to the 130% level required by its capital management policy) and thus retain control of their investment and allow it to continue trading and increasing its economic value through writing profitable new business. Alternatively they could decline to provide support and risk a situation in which Rothesay breaches its SCR and is forced to close to new business, or in which regulatory action means that significant decisions concerning the company are made using the PRA's powers of intervention. In such a situation, it is likely to be the rational choice for the investor to provide some further financing in order to protect the full value of its investment in Rothesay, and therefore it seems unlikely that some level of capital support would not be forthcoming from Rothesay's shareholders unless the level of recapitalisation required was prohibitively large relative to the underlying economic value of Rothesay's business. In this context, it is relevant to note that the terms of the recent share sale by Blackstone, described in paragraph 6.5, implied a total value of £5.9 billion for Rothesay's shares.
- Rothesay's shareholders will have reputational considerations that may mean they would be reluctant to refuse to provide support to Rothesay. For example, one of Rothesay's two major shareholders is a large, regulated insurance company in the U.S., and such investors are likely to have a low appetite for the type of reputational damage that could ensue if Rothesay were allowed to fail.

8.96 PAC would have similar actions available to it, and additionally PAC is currently part of a listed insurance and asset management group which currently has significant financial resources. However, as described in paragraph 8.39, the liquid capital resources available at the M&G plc level cannot reliably be assumed to be available to PAC at some point in the future over and above the level legally committed.

8.97 Taking these factors into account, I am satisfied that both firms have an adequate range of actions at their disposal to mitigate a scenario in which their solvency position starts to deteriorate, and therefore there is no material adverse impact on the security of benefits of the Transferring Policyholders arising from any change in the range of available actions in such circumstances.

Governance surrounding the capital management policies and risk appetite

8.98 PAC's target capital buffers are recalculated on a half-yearly basis. PAC's SRA Framework and limits are approved by the PAC Board.

8.99 The Rothesay capital management policy and associated limits are approved by the Rothesay Board; the policy is reviewed at least on an annual basis. The Scheme is expected to have no impact on Rothesay's capital management policy, although the capital management policy will remain under regular review by the Rothesay Board to ensure that it remains appropriate.

8.100 In theory, the PAC and Rothesay Boards are free to make changes to their respective capital management policies at any time, including making them weaker in terms of the level of SCR Coverage Ratio that is targeted. However, in practice, I would expect the PRA to be notified in advance by each firm of any material planned changes to its capital management policy. Furthermore, I consider it unlikely that PAC or Rothesay would be willing to countenance any material changes to their respective capital management policies if those changes did not meet with the non-objection of the PRA.

8.101 Taking this into account, I am satisfied that appropriate safeguards are in place in Rothesay to ensure that there is no material impact on the security of benefits of the Transferring Policies arising from the change in governance applicable to the capital management policy covering the Transferring Business.

Conclusion on the financial resources available to provide security of benefits

8.102 Based on the analysis above, I am satisfied that:

- The capital management policy of Rothesay will provide adequate support for the security of benefits of the Transferring Policies;
- The cessation of the Reinsurance Agreement and the associated restrictions on assets held in the custody accounts will not have a material adverse effect on the security of benefits for the Transferring Business; and
- Based on the financial position of the Companies at 31 December 2020 and other analysis with which I have been provided, the Scheme will not have a material adverse effect on the financial resources available to support the security of the benefits of the Transferring Business.

8.103 For these reasons, I am satisfied that the implementation of the Scheme will not have a material adverse impact on the financial resources available to provide security of benefits under the Transferring Policies.

THE PROFILE OF RISKS TO WHICH THE TRANSFERRING POLICIES ARE EXPOSED

8.104 After the implementation of the Scheme, the Transferring Policies will be direct policies of Rothesay and therefore directly exposed to the risk profile of a company that has written a different mix of business, through different distribution channels, to policyholders with different demographic profiles, and that has a different investment strategy.

8.105 The dominant risks for the PAC Shareholder-Backed Business are:

- Market risks, primarily arising from the impact of market shocks on the value of future shareholder transfers expected to be received from the PAC's With-Profits Fund[81];
- Credit risk, i.e. the risk of losses arising from the default of PAC's asset counterparties, or the risk of a reduction in the value of PAC's assets due to the downgrade of its investments or a widening of spreads (see paragraphs 4.74 and 4.75); and
- Insurance risks:
    - longevity risk, i.e. the risk of an adverse financial impact arising from its policyholders (primarily recipients of annuities) living longer than expected;
    - expense risk, i.e. the risk of losses caused by differences between the actual timing and/or amount of expenses incurred and those expected; and

[81] In the event of a market downturn, the financial position of the PAC With-Profits Fund could become more constrained, which would reduce the capacity of the PAC With-Profits Fund to declare discretionary bonuses on with-profits policies, which would in turn reduce the expected future shareholder transfers payable to the PAC SHF.

- persistency risk, i.e. the risk of losses caused by deviations of the actual rates of policy lapses from their expected rates.

8.106 In addition, the Transferring Policies are exposed to contagion risk from the PAC With-Profits Fund. In particular, in the unlikely circumstance that the depletion of the excess assets within one or more of the with-profits sub-funds of the PAC With-Profits Fund was such that the ability of PAC and the wider M&G Group to meet policyholders' reasonable expectations was adversely affected, it might become necessary to provide financial support to those with-profits sub-funds using capital resources of the PAC Shareholder-Backed Business. In particular, PAC is currently exposed to the consequences of the Pension Mis-selling Costs Assurance (see paragraph 5.61 and 5.62). After the proposed transfer, the Transferring Policies will no longer be exposed to any risks arising from the PAC Pension Mis-selling Costs Assurance.

8.107 Rothesay's main risks arise from its assets under management (credit and interest rate risk), pension liabilities (predominantly longevity risk) and counterparty default risk from its reinsurance and derivative counterparties.

8.108 Following the implementation of the Scheme, the Transferring Policies will no longer be exposed to risks associated with PAC's wider business and subsidiaries (including risks associated with the Pension Mis-selling Costs Assurance, and contagion risk from the PAC With-Profits Fund) but they will be exposed to a different range of risks. In particular, Rothesay invests in a different range of assets to PAC and Transferring Policies will be exposed to the risks of those assets rather than the risks of PAC's assets.

8.109 Rothesay's investment strategy seeks exposure to a higher proportion of unlisted and relatively illiquid assets than PAC's. However, the nature of Rothesay's liabilities (i.e. predominantly in-payment annuities) is such that there is a limited requirement for liquidity to meet unexpected outgo to policyholders, given that policyholders do not generally have the option to surrender their annuities in exchange for a lump sum[82]. Instead, Rothesay's principal exposure to liquidity risk arises from its extensive use of derivatives to hedge some of its market risk exposures (e.g. exposures to interest rate movements); this means that, should there be a significant movement in market interest rates, market-implied inflation rates or exchange rates, there could (depending on the direction of the movement) be a requirement for Rothesay to liquidate some of its assets in order to post collateral to support its obligations under the derivative contracts.

8.110 As described in paragraph 6.55, Rothesay also considers that it is exposed to risks related to changes in the regulatory and legislative environment. However, while it is not possible to know how such risks might manifest themselves, Rothesay believes that any manifestation of this category of risk would be more likely to represent a threat to its strategy and its shareholder returns rather than a threat to its solvency position and its ability to pay its policyholders. In order to impair Rothesay's ability to pay its existing policyholders, any legislative or regulatory change would need to:

- Materially impair the value of Rothesay's investments;
- Materially increase the annuity liabilities that Rothesay is committed to meet; or
- Materially reduce the level of reserves and capital requirements that Rothesay is required to hold against its liabilities, which would allow Rothesay to hold a lower value of assets to meet the same liabilities.

8.111 I agree with Rothesay's assessment. Any regulatory or legislative changes that threatened the benefit security of Rothesay's policyholders would be likely to have a similar adverse effect on the retirement incomes of millions of other UK pensioners. I would expect any regulatory or legislative changes that materially affected the solvency of UK life companies to be introduced in a way that mitigated any detriment to the interests of existing policyholders.

Climate risk

8.112 PAC and Rothesay have provided updates to me on the work they are carrying out around climate risk. Neither PAC nor Rothesay expects their businesses to be exposed to direct risks from climate change, but in common with all

[82] Some holders of Transferring Policies, principally holders of deferred annuities, are eligible to elect to commute some of the contractual benefits of their policy. This is described in more detail in paragraphs 8.147 to 8.149.

institutions with material financial investments, there is a potential exposure to so-called “transition risk” arising from the transition to a low-carbon economy, which could adversely affect the value or marketability of certain categories of investment.

8.113 The PRA set out its expectations in a “Dear CEO” letter[83] dated 1 July 2020 that the firms it supervises (including insurers) will be required to have fully embedded their approaches to managing climate risks by the end of 2021. Additionally, all UK insurers will be required to meet the requirements of the Task Force on Climate-related Financial Disclosures (“**TCFD**”)[84] by 2025.

8.114 PAC and Rothesay intend to be fully compliant with their regulatory and other requirements in this area. However, Rothesay has informed me that its inaugural ESG[85] Report will be published in 2021 and will have regard to the recommendations of the TCFD, and Rothesay does not currently anticipate making material changes to its investments as a result.

8.115 PAC and Rothesay have both committed to achieve net zero carbon emissions from their respective investment portfolios by 2050.

8.116 The extent to which climate change and actions taken to tackle it will affect PAC and Rothesay is currently highly uncertain, but it is likely that both Companies would be similarly affected, and both Companies are taking similar actions in response to this area.

8.117 I am therefore satisfied that the Companies’ exposure to climate risk will not have a material adverse effect on the security of benefits under the Transferring Policies.

Rothesay’s exposure to investments linked to ground rent payments

8.118 As at 31 December 2020, Rothesay has approximately £3 billion of investments linked to ground rent payments on leasehold properties. These investments involve Rothesay making a loan repayable by instalments of principal and interest, which may escalate, and which are funded from the ground rent payments received on a portfolio of leasehold properties.

8.119 Under these investments, the ground rent payments, as well as certain other ancillary income, are paid into a “reserve account”, which is an account controlled by Rothesay. The funds in the reserve account are then used to pay the interest and principal on the loans to Rothesay when due.

8.120 Under these investments, Rothesay has security over a number of assets, including the freehold of the properties, the funds in the reserve account, and rights to receive the ground rent income on the underlying properties.

8.121 The loans amortise over their lifetime and the pattern of this amortisation is matched to the ground rent income received.

8.122 Given that the UK Government has announced plans to make changes to the rights of leaseholders and the operation of leasehold properties in England and Wales (“**Leasehold Reform**”), which could have a negative financial impact on such investments, it is relevant for me to comment on the risks associated with these investments.

8.123 In relation to ground rent-linked investments generally, Rothesay has shared details of its approach to such investments, including the associated security, its approach to ensuring an appropriate coverage of the contractual loan cash flows by the value of the underlying collateral, and its due diligence processes before and after entering into such investments. I am satisfied that Rothesay has undertaken a robust risk assessment process in relation to these investments, and that the security available to Rothesay in the event of a default by the borrower means that Rothesay is well protected against default risk.

8.124 In relation to Leasehold Reform, I note that:

[83] https://www.bankofengland.co.uk/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change

[84] https://www.fsb-tcfd.org/

[85] Environmental, Social and Governance

- The principal impact of Leasehold Reform from the perspective of ground rent-linked investments will be to afford leaseholders more freedom in the area of enfranchisement[86], which can result in ground rent payments being extinguished. This would involve payment of compensation to the freeholder, but in some cases this payment could be less than the value of the ground rent payments that would be lost.
- Rothesay already holds capital against similar risks to those associated with the outcome of Leasehold Reform, and therefore Rothesay's financial position at 31 December 2020 includes allowance for a plausible outcome of Leasehold Reform; nevertheless there remains a risk of an outcome that is financially more adverse than expected.
- Rothesay has shared an estimate of a plausible financial impact from Leasehold Reform on its Solvency II financial position, which is relatively modest in the context of its excess assets, and would not come close to a scenario in which Rothesay breaches the requirements of its capital management policy (based on the financial position at 31 December 2020).
- Rothesay currently has no plans to materially increase its exposure to ground rent-linked investments.

8.125 In addition, Rothesay believes it has plausible mitigants against severe financial impacts from more radical political reforms relating to leasehold properties, which in any case Rothesay believes to be very unlikely to come about in the foreseeable future given the nature of the Leasehold Reform proposals. Over the longer term, the level of coverage of the contractual loan cash flows by the value of the underlying collateral is expected to increase as the loan amount amortises, and therefore Rothesay will be less exposed to any legislative changes that come about.

8.126 It should be noted that, on 12 May 2021, the UK Government published the first of its planned bills relating to leasehold reform, the contents of which are consistent with Rothesay's expectations and therefore Rothesay believes its existing risk assessment in this area remains valid. The proposals that were published only apply to new leases granted after the bill becomes law, and consequently the legislation does not affect Rothesay's loan portfolio linked to ground rent payments, or its security package, or the ability of freeholders to collect ground rent payments to which they are entitled.

8.127 Given the size and nature of Rothesay's exposure to ground rent-linked investments at 31 December 2020, and the quantum of the potential impact of Leasehold Reform, I am satisfied that Rothesay's exposure to the risks associated with ground rent-linked investments will not have a material adverse effect on the security of benefits under the Transferring Policies.

Rothesay's exposure to lifetime mortgages

8.128 Both Rothesay and PAC have investments in lifetime mortgage assets (often also referred to as equity release mortgages). The valuation and capital treatment of lifetime mortgage assets by insurers has received some publicity in the financial press, and I have received a letter expressing concerns about Rothesay's lifetime mortgage assets from a Transferring Policyholder. It is, in my view, therefore appropriate for me to comment on this matter in this Report.

8.129 At 31 December 2020, Rothesay's lifetime mortgage investments were valued at £4.3 billion and PAC's were valued at £1.8 billion.

8.130 Lifetime mortgages are products offered to the over-55s which provide a loan secured on the customer's main residence. Interest payments are typically not made; instead interest rolls up at a fixed rate for life and is repaid along with the loan advance when the loan is redeemed. Lifetime mortgages are redeemed upon the death of the customer or upon their earlier entry into long-term care, although earlier, voluntary, redemptions are also permitted (potentially subject to early repayment charges). Lifetime mortgages offer a no-negative-equity-guarantee ("**NNEG**") to the customer, which guarantees that the net sale proceeds from the sale of the customer's property will be sufficient to repay the mortgage. This means that Rothesay would receive less than the full loan amount plus accrued interest if this was greater than the proceeds received from the sale of the underlying property upon the redemption of the loan.

[86] Enfranchisement means enabling leaseholders to buy the freehold interest or extend the lease.

The presence of the NNEG exposes firms offering lifetime mortgages to the risk of falls in, or underperformance of, residential property values as this increases the risk that the NNEG results in losses to the firm.

8.131 Lifetime mortgages are a popular investment for insurers writing annuity business as they are long duration assets with a fixed interest rate, which means that they provide a good match in duration terms for similarly long duration annuity liabilities. They are also relatively illiquid, as they are not traded on financial markets.

8.132 In their original form, lifetime mortgage assets do not generally meet the eligibility requirements for inclusion in a Matching Adjustment Portfolio as the timing of the cash flows under a lifetime mortgage are uncertain (as redemptions are triggered by the death of the customer), whereas the Matching Adjustment eligibility rules include a requirement that asset cash flows should be fixed. However, the PRA allows insurers to use special purpose entities, or similar vehicles, to restructure the cash flows from lifetime mortgage portfolios and create Matching Adjustment-eligible notes with fixed cash flows that can be held as assets in the insurer's Matching Adjustment Portfolio. The value of the residual cash flows from the lifetime mortgage portfolio (in excess of those required to meet the cash flows guaranteed under the notes) are an asset of the insurer but are not allocated to the Matching Adjustment Portfolio.

8.133 The valuation of lifetime mortgage assets is subject to some uncertainty; their market value is not readily observable as they are not traded on an exchange, and therefore insurers (and other issuers of lifetime mortgages) typically value them using a valuation model, which is an approach permitted by relevant financial reporting standards. The approach to the NNEG in the valuation of lifetime mortgages is subject to an industry debate, with differing views over the extent to which it is appropriate to take account of an insurer's views of future property price growth when determining the allowance to be made for the NNEG in the calculation of the mortgage value. Generally, NNEG valuations that do not rely on future property price growth are referred to as "risk-neutral" valuation approaches, and valuations that assume implicitly that property prices will continue to grow are referred to as "real world" valuation approaches. The industry debate focuses on whether real world approaches to NNEG valuation fully reflect the risks associated with the NNEG.

8.134 To the extent that lifetime mortgages are restructured as described in paragraph 8.132, the restructured mortgage notes are, as a result of their fixed cash flows, permitted to contribute to the size of the insurer's Matching Adjustment. In the same way that it would not be appropriate for the Matching Adjustment contribution from a bond to include that part of the bond spread representing compensation for the risk of that bond's default, it would also be inappropriate for the Matching Adjustment contribution from a lifetime mortgage to include that part of the mortgage's yield representing compensation for the risk associated with the NNEG.

8.135 At 31 December 2020, restructured lifetime mortgages with a value of £3.3 billion (out of a total lifetime mortgage portfolio of £4.3 billion) were held in Rothesay's Matching Adjustment Portfolio. PAC held restructured lifetime mortgages with a value of £1.3 billion[87] (out of a total lifetime mortgage portfolio of £1.8 billion) in its Matching Adjustment Portfolio.

8.136 As the PRA has oversight over the level of Matching Adjustment benefit enjoyed by insurers, it has issued regulations in Supervisory Statement 3/17 ("**SS3/17**")[88] in relation to the level of Matching Adjustment benefit that is appropriate to assign to lifetime mortgage assets, and in particular has set out details of a diagnostic test (the "**Effective Value Test**" or "**EVT**") that it uses to identify insurers who may be deriving an inappropriately large Matching Adjustment benefit from lifetime mortgages. The EVT sets out an approach to the NNEG that does not rely on positive future property price growth, i.e. it is an example of a risk-neutral valuation approach, and the PRA expects insurers to be in full compliance with the requirements of SS3/17 (including those around the EVT) by the end of 2021. Consequently, to the extent that insurers use a valuation approach in relation to the NNEG that is less prudent than that set out under the EVT, the Matching Adjustment will, in effect, be restricted to ensure that the allowance for NNEG risk at least reflects the PRA's EVT approach.

[87] While £1.3 billion of restructured lifetime mortgages were allocated to PAC's Matching Adjustment Portfolio at 31 December 2020, only £0.9 billion of these contributed to the size of PAC's Matching Adjustment. The remaining mortgages were not held to directly match liability cash flows; instead they were held in order to meet the PRA's matching tests described in paragraph 6.19.

[88] https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss

8.137 Rothesay has provided information to me on its approach to underwriting and risk management for its lifetime mortgage assets, and it is relevant to note that:

- Properties associated with all new lifetime mortgages are physically inspected by a qualified surveyor in order to ensure the property value is being accurately assessed, with secondary assessments for high value properties;
- Rothesay uses a number of techniques to regularly revalue all properties underlying its lifetime mortgage portfolio, in order that its estimates of the property values are as accurate as possible;
- Rothesay believes that it has stricter lending criteria than the market average in a number of areas; and
- Rothesay believes that it takes a conservative view of future house price growth for the properties underlying its lifetime mortgage portfolio.

8.138 In relation to the NNEG, Rothesay has informed me that it complies with the EVT and the wider relevant requirements of SS3/17 in full, and in particular Rothesay did not make use of the PRA's permitted phasing-in period in relation to the EVT, which provides temporary additional relief prior to 31 December 2021, in order to meet the PRA requirements. In addition, Rothesay's PIM application, which was reviewed and approved by the PRA, included information demonstrating Rothesay's compliance with the EVT. This means, among other things, that the Matching Adjustment benefit it receives from its lifetime mortgage asset is no larger than a benefit that would be consistent with the risk-neutral NNEG valuation approach prescribed by the PRA. PAC has also informed me that it complies with the EVT in relation to its lifetime mortgage portfolio.

8.139 In addition, I have reviewed the assumption for future house price growth used in Rothesay's valuation of its lifetime mortgage portfolio and consider it to be conservative. In view of this, and given that:

- the portfolio complies with the EVT, and
- the information with which I have been provided shows that Rothesay has appropriate underwriting and risk management processes related to lifetime mortgages,

I am satisfied that Rothesay's exposure to lifetime mortgages will not have a material adverse effect on the security of benefits under Transferring Policies.

Liquidity risk

8.140 In addition to its illiquid assets, Rothesay invests heavily in UK government bonds (which are relatively liquid), and has an extensive range of liquidity management tools in place to ensure it is able to meet expected and unexpected liquidity requirements, including under stressed market conditions. In addition, Rothesay performs stress tests to its liquidity position on a weekly basis. The Transferring Business is similar in nature to the business that Rothesay already has, and therefore does not present any materially new or different challenges from a liquidity management perspective. Furthermore, the implementation of the Scheme will not have a material impact on Rothesay's liquidity position as any additional liquidity requirements relating to the Transferring Business have already been transferred to Rothesay under the Reinsurance Agreement (which covers the Transferring Policies). Rothesay's liquidity policy specifies that, when any potential new transactions are presented to Rothesay's 'Transaction Approval Committee' or 'Working Level Risk Committee', a summary of liquidity implications must be included. For material transactions, the following information is considered:

- How the transaction would be funded,
- The impact of the activity on liquidity coverage ratios[89]; and
- An assessment of the impact of any encumbrance of Rothesay's assets on Rothesay's liquidity position.

[89] A liquidity coverage ratio is usually defined as the ratio of the insurer's available liquid resources to the insurer's net expected outgoings, measured over a given period.

Rothesay has confirmed to me that this policy was followed in relation to the Reinsurance Agreement, and that action was taken as necessary to protect Rothesay's liquidity position.

8.141 In view of this, and the illiquid nature of Rothesay's liabilities, I do not consider this increase in exposure to illiquid assets for Transferring Policies to be of concern.

Other comments on risk exposures

8.142 More generally, PAC's business mix is more varied than Rothesay's and, therefore, the Transferring Policies are currently exposed to a greater variety of risks than they would be after the implementation of the Scheme. Therefore, the proposed transfer will reduce the range of risks to which the Transferring Policies are exposed, but it will also reduce the levels of risk diversification from which the Transferring Policies benefit. However, the SCR that Rothesay is required to hold under Solvency II will reflect the risk profile of the company, its business and any diversification benefits that are available.

8.143 In addition to the capital that Rothesay is required to hold:

- Rothesay has an internal risk management framework that documents its approach to identifying, measuring, monitoring, managing and reporting its risks.
- As part of its risk management framework, Rothesay maintains a risk appetite statement that identifies and quantifies the risk exposures that Rothesay is prepared to accept in order to meet its strategic objectives, and Rothesay carries out regular monitoring and actions to ensure that its risk exposures remain within its risk appetite.
- Rothesay has an independent Risk and Compliance Function whose role is to provide oversight, advice and challenge to management and the Board in order to ensure that business risks are managed effectively, and a Board which includes experienced non-executive directors.
- Rothesay is required to produce an ORSA regularly (and following any significant change), which describes the profile of risks to which the company and its future plans are subject, and quantifies its exposure to its key risks through extensive stress and scenario testing.[90]

8.144 All of the risk management activities described in paragraph 8.143 are common to all of the large life insurers in the UK. Nevertheless, they provide additional comfort that any differences in risk profile to which the Transferring Policies will be exposed after the implementation of the Scheme will be suitably identified, managed and protected against.

Conclusion in relation to the profile of risks to which Transferring Policies will be exposed

8.145 In conclusion I am satisfied that the impact of the implementation of the Scheme on the profile of risks to which the Transferring Policies will be exposed will not have a material adverse effect on the security of benefits under the Transferring Policies.

THE REASONABLE EXPECTATIONS OF TRANSFERRING POLICYHOLDERS

8.146 The Transferring Policies are non-profit in-payment annuities[91], and the contractual benefits they provide will be unchanged by the Scheme. Policyholders' reasonable expectations in respect of their policies are principally that:

- The administration, management, and governance of the policies are in line with the contractual terms under the policies;
- The standards of service received are not materially adversely affected by the transfer; and
- Any discretionary benefits are fair and consistent with current practice.

[90] My assessment of the Scheme has included consideration of the most recent ORSAs prepared by Rothesay and PAC.

[91] With the exception of 6 deferred annuities.

Benefit expectations of the Transferring Policyholders

8.147 While annuity payments are guaranteed and will not change following the implementation of the Scheme, in certain situations some holders of Transferring Policies are eligible to elect to commute some of those payments; that is, to forgo some or all of their annuity income in return for a lump sum payment. The circumstances in which this is permitted for in-payment annuities are limited, comprising:

- Where, following the death of an annuitant, the benefits subsequently payable to a contingent beneficiary are small enough to qualify for trivial commutation[92]; or
- Where a pension sharing order[93] has been granted.

8.148 The circumstances in which holders of the 6 deferred annuities that are within the scope of the transfer may elect to commute some or all of their benefits are less restricted than for in-payment annuities. In particular, deferred annuity holders may elect to take a Pension Commencement Lump Sum ("**PCLS**")[94]. These policyholders may also elect to commute their benefits where they have funds below a certain size (typically £30,000), or in cases of ill health. Commutation is also used to calculate transfer values in situations where deferred annuity policyholders choose to transfer their pension entitlements to another pension provider.

8.149 The terms on which commutation takes place are not guaranteed in the policy terms and conditions and are determined by the relevant company using its discretion, subject to the requirement to treat customers fairly.

8.150 Currently, if some or all of the benefits of a Transferring Policy were to be commuted, the lump sum payment would be calculated using PAC's prevailing commutation factors[95]. By contrast, after the proposed transfer, the Transferring Policies' commutation benefits will be calculated using Rothesay's prevailing commutation factors.

8.151 PAC and Rothesay each have a practice of offering full commutation to widow(er)s at the point of death of the primary member. These lump sums are offered up to a total value of £30,000, which aligns to the limits currently applicable to trivial commutations. PAC's practice is only to offer lump sums to group policies and they not available on policies derived from individual personal pensions. By contrast, Rothesay's practice is to offer lump sums for both group and personal pension policies, and therefore contingent beneficiaries of Transferring Policies arising from the proceeds of personal pensions will, as a result of the transfer, gain the option to commute their benefits if these benefits fall below the £30,000 threshold. PAC estimates that of the order of 30,000 Transferring Policies could potentially meet the criteria to be eligible to take trivial commutation for contingent beneficiaries as policies of PAC, subject to various other requirements. By contrast, upon transferring to Rothesay it is estimated that of the order of 90,000 additional Transferring Policies could potentially become eligible for trivial commutation for contingent beneficiaries, owing to Rothesay's practice of allowing trivial commutation for contingent beneficiaries of holders of personal pensions.

8.152 Given that commutation of benefits is more commonly carried out for deferred annuities than for in-payment annuities, and almost all of the Transferring Policies are in-payment annuities, the proportion of Transferring Policyholders likely to be affected by any differences in the companies' prevailing commutation factors is small in comparison to the number of Transferring Policies[96].

[92] Trivial commutation is permitted where the assessed value of the pension payable (i.e. the annual pension entitlement multiplied by 20) is less than £30,000.

[93] A pension sharing order is a court order that some or all of the policyholder's benefits are paid to the policyholder's former spouse with any remainder being paid to the policyholder.

[94] A Pension Commencement Lump Sum refers to a tax-free lump sum that individuals are permitted to receive from their pension scheme or pension policy when they crystallise their pension benefits. In most cases, the lump sum that can be received is limited to no more than 25% of the value of the individual's pension benefits. Amounts up to the policyholder's applicable Lifetime Allowance ("**LTA**") are free of tax; any amount in excess of the LTA is subject to tax at 55%.

[95] A commutation factor is the lump sum received by the policyholder for each £1 p.a. of pension income forgone. For example, a commutation factor of 20 means that the policyholder would receive a £20 lump sum for each £1 p.a. of pension forgone.

[96] In 2020, 463 deferred annuity policyholders (out of approximately 8,606 deferred annuity policies within the Reinsured Business) and 379 in-payment annuity policyholders (out of approximately 376,000 in-payment annuity policies within the Reinsured Business) chose to commute some or all of their benefits. In percentage terms, this corresponds to approximately 5.4% of the deferred annuity policies and 0.1% of the in-payment annuity policies.

8.153 I have reviewed analysis performed by the Companies which compares PAC's and Rothesay's current commutation factors applicable to trivial commutations for a sample of ages and benefit types.

8.154 The factors for each company comply with that company's interpretation of the requirement to treat customers fairly and other applicable regulations; however, there are differences in the companies' views on future mortality and inflation rates, which affect the value of policyholders' commutation benefits. In addition, the discount rates used to calculate the commutation benefits differ between the companies due to differences in the profile of assets held by each company and the associated expected returns on those assets.

8.155 The analysis I have received shows that, based on the currently applicable commutation factors, for the sample of ages and benefit types considered in the analysis, while there are differences for individual policies depending on the age of the policyholder and the policy features, Rothesay's commutation factors are within a range of ±3.5% of PAC's commutation factors. Rothesay's factors are generally higher than PAC's factors (albeit still within 3.5%) for policies that have fixed annuity amounts or that are subject to fixed annual increases to their annuity amount; conversely, policies with inflation-linked increases will generally be subject to slightly lower commutation factors in Rothesay than under PAC's basis.

8.156 A 3.5% difference would correspond to a difference in lump sum received of £350 for a commuted amount of £10,000, which I understand was approximately the average lump sum paid by PAC upon trivial commutation in 2019.

8.157 There are 6 deferred annuities within the Transferring Business which all arise from one transferring pension scheme which is subject to a buy-in with PAC and which consists mainly of in-payment annuities. In order to facilitate the transfer of this pension scheme in its entirety, those deferred annuities will form part of the Transferring Policies. All other Transferring Policies are in-payment annuities.

8.158 For the 6 deferred annuity policies within the scope of the transfer, Rothesay and PAC have agreed an arrangement whereby the commutation terms offered by Rothesay will be enhanced, if necessary, by an amount based on the differential between PAC's and Rothesay's commutation factors; the analysis and determination of this differential has already been agreed by Rothesay and PAC for each of the deferred annuity policies but can be reviewed, and if necessary amended, prior to the transfer to the extent that the differential changes. The effect of this agreement is to ensure that the commutation terms offered to deferred annuitants will be increased to the extent that, as at the date of the commutation analysis, PAC offered more favourable commutation terms than Rothesay. Any changes to the differential, whether upwards or downwards, between PAC's and Rothesay's prevailing commutation factors after the date of this analysis will not be reflected in any commutation enhancement.

8.159 Given that:

- the differences in commutation factors produced by Rothesay's and PAC's respective bases are relatively small, and there appears to be no systematic upward or downward bias between the two sets of commutation factors;
- all but a handful of the Transferring Policies are in-payment annuities, and therefore the circumstances in which commutation of benefits may take place are limited for these policies; and
- for the 6 Transferring Policies that are deferred annuities, PAC and Rothesay have agreed the arrangement described in paragraph 8.158. This ensures that the commutation terms offered will be adjusted to compensate for any **current** shortfall in Rothesay's commutation factors relative to PAC's factors,

I am satisfied that the impact of the implementation of the Scheme on the commutation terms available to Transferring Policyholders will not materially affect the benefit expectations of Transferring Policyholders. I will comment on the final outcome of the review of PAC's commutation basis in my Supplementary Report.

8.160 It is also important to note that the commutation bases for both PAC and Rothesay are not guaranteed and may change in the future. Therefore, the differences between the respective bases may narrow, or widen, in the future. However, any substantive change to either company's approach would be subject to the obligation to treat customers fairly.

8.161 Taking the above into account, I am satisfied that the implementation of the Scheme will not have a material adverse effect on the reasonable benefit expectations of the Transferring Policies.

The administration and service standards applied to the Transferring Policies

8.162 Since 1 October 2018, the administration of the Transferring Business has been outsourced to TCS/Diligenta. As described in paragraph 7.38 PAC and Rothesay have executed a TSA that will come into force upon the implementation of the Scheme, under which PAC will continue to provide administration services (provided by TCS/Diligenta on its behalf) in respect of the Transferring Policies to Rothesay following the Transfer Date for a period expected to be approximately 6 to 12 months.

8.163 Therefore, while the TSA is in place, there is no reason to expect that administration and service standards will differ from those that the Transferring Policies would have received if the Scheme had not been implemented.

8.164 Once Rothesay has completed the transfer of the administration arrangements applicable to the Transferring Policies to another service provider of its choice, the TSA will terminate.

8.165 Rothesay has shared with me its migration plans for the Transferring Business, and this includes a line-by-line comparison of the service standards currently agreed between PAC and TCS/Diligenta and those that would be provided by Rothesay's administration partner, to ensure that service standards applicable to Transferring Policies are as good or better than those currently experienced.

8.166 In relation to Rothesay's internal processes for such migrations, I have been informed that Rothesay's Chief Operating Officer is the individual formally responsible under the PRA's and FCA's Senior Managers Regime for overseeing the transfer of administration arrangements. In doing this, the Chief Operating Officer will be assisted by a number of Rothesay's internal committees, including its Customer and Conduct Committee which will focus on the potential for any customer detriment from the transfer.

8.167 The Customer and Conduct Committee is chaired by one of Rothesay's Independent Non-Executive Directors and its role is to assist Rothesay in ensuring that it consistently delivers fair outcomes to customers, clients and counterparties. Its duties include:

- Ensuring adherence to the FCA "Treating Customers Fairly" outcomes;
- Identifying and considering wholesale conduct risks and market integrity issues arising from the investment strategy;
- Reviewing Rothesay's management and measurement of conduct risks; and
- Overseeing Rothesay's response to policyholder complaints.

8.168 Notwithstanding the responsibilities of the COO and the Customer and Conduct Committee, Rothesay's Board of Directors will retain ultimate responsibility for all aspects of the transfer.

8.169 I understand that, as part of the planning for the migration, the nature of the operational management of the migration will be agreed. This will include the formation of any joint steering committees, project teams involving individuals from Rothesay and PAC, as well as their respective third party administration partners, and escalation routes when issues arise; the precise nature of these processes has not yet been determined and therefore I cannot describe them in this Report. I will comment further on these arrangements in my 2021 Supplementary Report.

8.170 Rothesay has entered into a significant number of large transactions in recent years, covering direct transactions with defined benefit pension schemes and transactions with insurance companies (for example, Zurich Assurance Ltd. and Scottish Equitable plc) to acquire portfolios of annuities, and therefore it has a track record in ensuring that administration "onboarding" goes smoothly. To ensure this, it uses a panel of three pension administration providers, which provides capacity and flexibility to cope with large transactions or multiple concurrent transactions.

8.171 Rothesay's most recent large transactions were announced in late 2019 (which, in aggregate, were larger in terms of liabilities than the Transferring Policies under the Scheme), and two of these transactions were structured as buyouts, which require Rothesay to issue individual policies to the affected pension scheme members; this requires a similar process to that which will be required to migrate the administration of the Transferring Policies upon the termination of the TSA. The migration process for one of these buyout transactions has been successfully completed, and the other migration process is expected to complete in the coming months.

8.172 More generally, it is common for UK insurers to use outsourced administration providers and, moreover, to migrate their administration to a new outsourced provider from time to time. Such migrations do not typically require a court process, regulatory approval or a report from an independent expert, although the FCA provides continuing regulatory oversight of third party outsourcing arrangements.

8.173 In addition, both companies have an incentive for the process of administration migration to go smoothly, as financial service companies are required to ensure customers are treated fairly and receive suitable levels of service. There is also a reputational requirement for a smooth transition of administration arrangements, as the Companies would also be at risk of adverse publicity if there were significant issues in such processes, for example incorrect or delayed payment of annuity benefits, and any insurer would therefore be keen to take steps to avoid this kind of situation.

8.174 PAC has shared with me its approach to vulnerable consumers[97] and PAC has confirmed that this approach will be maintained when administering the Transferring Policies under the TSA. I have also reviewed Rothesay's approach to vulnerable customers and I consider the two companies' approaches to be broadly comparable, and in particular there is no reason to believe that the treatment of vulnerable customers that hold Transferring Policies after the Transfer Date and after the expiry of the TSA will be materially different from the treatment they currently experience as policyholders of PAC. The Companies have also provided me with an update on how they are approaching the FCA's finalised guidance on the fair treatment of vulnerable customers ("**FG21/1**")[98], published in February 2021, and I am satisfied that both Companies are being proactive in ensuring that their approach to vulnerable customers remains consistent with market practice and regulatory guidance.

8.175 The PRA and FCA have also published policy statements[99] in recent months on expectations for ensuring the operational resilience of the firms that they supervise. Operational resilience is very important in ensuring that policy administration and customer service can continue to be provided during periods of disruption. The Companies have provided updates to me on their progress towards complying with the provisions of the respective policy statements, and I am satisfied that they are on track with their approach to meeting the relevant requirements.

The impact of COVID-19 on policy administration

8.176 Rothesay has provided me with information on the impact that the COVID-19 pandemic has had on its third party administration partners. This information indicates that Rothesay's administration partners have continued to maintain service levels within the agreed parameters during the pandemic despite receiving higher-than-usual volumes of work. Rothesay's complaint levels are low in relation to its number of policyholders, but complaint levels increased somewhat during the middle of 2020 before trending downwards to a normal level by the end of 2020.

8.177 A trend of increased levels of complaints during the pandemic is something that other insurance companies have also experienced and is not unique to Rothesay, and I note that Rothesay's policyholder experience surveys indicated that 95% of policyholders rated the service as either "excellent" or "good". I will comment further on any updates to information on service standards in my 2021 Supplementary Report.

[97] The FCA defines a vulnerable consumer as "someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care" - Occasional Paper No. 8 'Consumer Vulnerability', February 2018

[98] FG21/1 can be found here: https://www.fca.org.uk/publications/finalised-guidance/guidance-firms-fair-treatment-vulnerable-customers

[99] The PRA's policy statement 6/21 on operational resilience is here: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper

The FCA's policy statement 21/3 on operational resilience is here: https://www.fca.org.uk/publications/policy-statements/ps21-3-building-operational-resilience

8.178 Rothesay is monitoring the performance of its administration partners during this period by conducting daily conversations, including weekly calls involving senior management, with them and receiving daily information on performance.

8.179 In light of the above, I am satisfied that the transfer would not materially increase the risk of adverse outcomes for Transferring Policyholders as a result of COVID-19 in the areas of service standards and policy administration.

The impact of Brexit on policy administration

8.180 As described in paragraph 5.31, PAC transferred its business written through establishments in Europe to PIA effective from 1 January 2019. None of the Transferring Policies has, so far as PAC is aware, been sold through an overseas branch or on a freedom of services basis in any EEA State other than the UK and, as far as it is aware, PAC does not have any policies (including within the Transferring Business) for which the state of commitment of the policy was an EEA state that is not the UK ("**EEA Policies**"). However, I understand that it is not possible to state conclusively that there are no relevant policyholders for whom an EEA State other than the UK was the state of the commitment as that is a factual matter in each case and the analysis depends upon factors such as the habitual residence of the policyholder at the time that the contract was concluded.

8.181 Should it become apparent (either in advance of the transfer or otherwise) that any such EEA Policies are within the Transferring Business, they would still be transferred to Rothesay under the Scheme.

8.182 Neither PAC nor Rothesay has undertaken detailed work to ascertain how such EEA Policies would be lawfully serviced in the event that any such policies were discovered as they do not believe it would be proportionate to do so, given that PAC does not believe that any such EEA Policies exist. However, neither party considers that the payment of claims under policies would be problematic in practice in light of the recommendations issued by EIOPA to national supervisory bodies in EU jurisdictions on 19 February 2019 (the "**EIOPA Recommendations**")[100], which were developed to promote consistent supervisory practices in relation to the treatment of UK insurance undertakings by setting out guidance on matters relating to the loss of passporting rights. In particular, the general objective is that national supervisors, in their treatment of any cross-border business of UK insurance undertakings, should:

- aim to minimise any detriment to policyholders (Recommendation 1);
- apply a legal framework or mechanism to facilitate the orderly run-off of business which becomes unauthorised (Recommendation 2);
- consider applying any national continuity provisions that apply following a lapse of authorisation of an insurance undertaking in their jurisdiction to UK insurance undertakings (Recommendation 4); and
- take into account that, where a contract was concluded in the UK and the policyholder was habitually resident in the UK at the time and has since move to an EU jurisdiction, the insurance undertaking did not provide cross-border services in respect of that contract (Recommendation 6).

8.183 I am satisfied that this approach of the Companies is reasonable for the following reasons:

- It is difficult to envisage a scenario in which the existence of any EEA Policies of PAC (within or outside of the Transferring Business) would come to light, even in the unlikely scenario that such EEA Policies exist within PAC without PAC being aware of it; and
- National supervisory bodies in the EU were required to confirm their compliance or intention to comply with each of the EIOPA Recommendations within two months or else provide reasons for non-compliance. EIOPA subsequently published an overview of the replies received in March 2020, which indicated that each national supervisor either already complied or intended to comply with each of the EIOPA Recommendations, including those referenced above, with the exception of France in respect of Recommendation 6. However, PAC has

[100] https://www.eiopa.europa.eu/content/recommendations-insurance-sector-light-united-kingdom-withdrawing-european-union_en

obtained legal advice that France has implemented a continuity regime which would entitle it to continue to pay annuities to policyholders for whom the state of the commitment is France.

- In relation to the Transferring Policies, even if any EEA Policies within the Transferring Policies did come to light, I am not aware of any reason as to why any difficulties associated with servicing such EEA Policies would be materially different for Rothesay than for PAC, and therefore the implementation of the Scheme will not materially affect the likelihood that holders of EEA Policies would experience adverse outcomes in relation to policy servicing.

8.184 Should it become apparent that, contrary to its expectations, PAC does have one or more in-force EEA Policies, PAC (prior to the transfer) or Rothesay (after the transfer) would need to take appropriate legal advice in the relevant jurisdiction and consider any further steps that may be required under the relevant national rules implementing the EIOPA Recommendations.

8.185 Notwithstanding that PAC does not believe that it has any EEA Policies, PAC does have policies for which the state of commitment was the UK but whose holders are currently resident in the EEA; there are approximately 4,600 Transferring Policyholders in this category. PAC continues to pay the benefits due under these policies and to service these policies. Moreover, Rothesay also has policies in this situation and has informed me that it continues to service such policies as normal and is not aware of any impediment to it continuing to do so in light of the EIOPA Recommendations. Rothesay has also confirmed that it has existing policyholders (whose policies it continues to service) in all EEA countries in which Transferring Policyholders are currently resident. Rothesay has an update on its website in relation to Brexit[101] which confirms that it continues to meet its contractual obligations to policyholders resident in the EEA.

8.186 More generally, as for EEA Policies, it is difficult to envisage scenarios in which any impact arising from Brexit on the ability of Rothesay to service policies held by EEA residents would not affect PAC in a similar way, and therefore I am satisfied that the implementation of the Scheme will not exacerbate any potential consequences of Brexit for service standards for policyholders resident in the EEA.

Conclusion in relation to administration and service standards

8.187 Taking the above into account, I am satisfied that the implementation of the Scheme will not result in a material adverse impact on service standards experienced by holders of Transferring Policies.

Governance and management of the Transferring Policies

8.188 The Transferring Business is currently managed by PAC, and subject to the governance of the PAC Board.

8.189 Following the implementation of the Scheme, the Transferring Business will be managed by Rothesay and subject to the governance of the Rothesay Board. Rothesay currently manages large volumes of non-profit annuity business, including retail annuity business of the same type as the Transferring Business, and I consider that the Rothesay Board is experienced in the management and governance of non-profit annuity business and have no reason to believe that it will treat the transferring policyholders in a materially different way to the PAC Board.

8.190 In addition, Rothesay and PAC are subject to the same regulatory requirements in relation to the governance of their long-term insurance business. For example, both companies are required by PRA rules to appoint:

- A Chief Actuary, whose appointment is subject to PRA approval, and who is responsible for advising the company's Board of Directors, inter alia, on the reliability and adequacy of the calculation of the Technical Provisions; and

- A Chief Risk Officer, whose appointment is also subject to PRA approval, and who is responsible for the implementation of the insurer's risk management system.

[101] Rothesay's update can be found here: https://www.rothesay.com/brexit-update/

8.191 Unlike PAC, Rothesay is not required to appoint a WPA as it has no with-profits business, but none of the Transferring Business is with-profits and so this does not affect the governance applicable to the Transferring Business.

8.192 I am satisfied that the implementation of the Scheme will not materially adversely affect the standards of governance and management applicable to the Transferring Business.

Conclusions in relation to the reasonable expectations of Transferring Policyholders

8.193 Taking the conclusions in paragraphs 8.161, 8.187 and 8.192 into account, I am satisfied that the implementation of the Scheme will not have a material adverse effect on the reasonable expectations of Transferring Policyholders.

CONCLUSION FOR THE TRANSFERRING POLICIES

8.194 Overall, I am satisfied that the implementation of the Scheme will not have a material effect on:

- The security of benefits of the Transferring Policies; or
- The reasonable expectations of the Transferring Policyholders, including:
    - The reasonable benefit expectations of Transferring Policyholders; and
    - The standards of service, management and governance applicable to the Transferring Policies.

9. The effect of the implementation of the Scheme on the non-transferring policies of PAC

INTRODUCTION

9.1 In this section I consider the effect of the implementation of the Scheme on the non-transferring policies of PAC.

9.2 The non-transferring PAC policies comprise:

- Certain non-profit deferred and in-payment annuities in the PAC NPSF;
- Unit-linked policies in the PAC NPSF;
- With-profits policies and non-profit annuities in the PAC With-Profits Fund; and
- General insurance policies written in the PAC SHF.

9.3 For the avoidance of doubt, the commentary and conclusions in this section apply to the Non-Transferring Reinsured Policies (as described in paragraphs 7.20 to 7.22), and to any Excluded Policies (as described in paragraphs 7.17 to 7.19) while they remain policies of PAC.

THE FINANCIAL RESOURCES AVAILABLE TO PROVIDE SECURITY OF BENEFITS

9.4 The security that the holders of non-transferring policies in PAC enjoy with respect to their guaranteed benefits currently arises from the assets held by the company:

- Assets backing the Technical Provisions and SCR of the PAC Shareholder-Backed Business; and
- Excess capital resources of the PAC SHF and PAC NPSF; and
- In certain extreme scenarios, excess capital resources of the PAC With-Profits Fund.

9.5 The ability of Rothesay to fulfil its obligations under the Reinsurance Agreement currently affects the security for the non-transferring policies of PAC. In particular, in the event that Rothesay were unable to fulfil its obligations under this arrangement, the business of PAC as a whole would absorb any financial impact, not just the Transferring Policies. However, the Reinsurance Agreement is fully collateralised, with this collateral being held in custody accounts that are subject to eligibility criteria and rules for management.

9.6 Under the Scheme, the non-transferring policies in the PAC SHF, PAC NPSF and PAC With-Profits Fund, and the assets of those funds, other than:

- The asset representing the value of amounts recoverable from Rothesay in relation to the Transferring Policies under the Reinsurance Agreement; and
- The assets representing the value of amounts recoverable from the reinsurance treaties listed in Table 7.2;

will remain in the PAC SHF, PAC NPSF and PAC With-Profits Fund respectively.

9.7 The following table shows the pro forma post-Scheme financial strength of the PAC Shareholder-Backed Business as at 31 December 2020 on the Solvency II Pillar 1 basis.

TABLE 9.1 – THE PAC SHAREHOLDER-BACKED BUSINESS PRE-TRANSFER AND PROJECTED POST-TRANSFER SOLVENCY POSITION AS AT 31 DECEMBER 2020

	PAC Shareholder-Backed Business, pre-Scheme	PAC Shareholder-Backed Business, post-Scheme	Impact of Scheme
	£m	£m	£m
Solvency II Assets (net of other items)	59,704	48,748	*(10,956)*
Technical Provisions (including TMTP)	50,987	40,038	*(10,949)*
Own Funds (A)	**8,718**	**8,711**	***(7)***
SCR (B)	5,107	4,970	*(137)*
Excess Capital (=A-B)	3,611	3,741	*130*
SCR Coverage Ratio (A/B)	***171%***	***175%***	***5%***

Totals/differences may not be additive due to rounding

9.8 PAC's consolidated regulatory solvency ratio was 136% as at 31 December 2020. The impact of the Scheme, if it had occurred at this date, would be to increase this ratio to 138%.

9.9 Table 9.1 shows that, if the transfer occurred at 31 December 2020, it would result in a reduction in PAC's Own Funds of approximately £7 million; however, the SCR for the PAC Shareholder-Backed Business would be expected to reduce by £137 million as a result of the Scheme, leading to a net increase in Excess Capital for the PAC Shareholder-Backed Business of £130 million. This is equivalent to an increase of 5 percentage points in the SCR Coverage Ratio for the PAC Shareholder-Backed Business.

9.10 The £7 million estimated reduction in the Own Funds of the PAC Shareholder-Backed Business reflects a number of offsetting effects of the Scheme, namely:

- Equal, offsetting reductions in assets and liabilities arising from the release of the BEL of the Transferring Business and the loss of the value of future amounts recoverable from Rothesay in relation to the Transferring Policies.

- An increase in Own Funds arising from the fact that PAC will incur lower administration costs from its third party servicing providers after the implementation of the Scheme as a result of the lower volumes of business required to be serviced.

- An increase in Own Funds arising from a reallocation of future fixed costs between the PAC Shareholder-Backed Business and the PAC With-Profits Fund. This comes about because PAC is required to hold a liability in its Solvency II balance sheet in relation to future expenses incurred in servicing its insurance obligations, including the portion of its fixed costs (i.e. overheads) that PAC deems to relate to such servicing. PAC's practice is to allocate its fixed costs for the purpose of determining this liability between the PAC Shareholder-Backed Business and the PAC With-Profits Fund in proportion to the size of these funds (among other factors), and as the implementation of the Scheme will result in a reduction in the size of the PAC Shareholder-Backed Business relative to the PAC With-Profits Fund, the allocation of fixed costs to the PAC Shareholder-Backed Business will reduce, resulting in an increase in the Own Funds of the PAC Shareholder-Backed Business.

- A reduction in Own Funds arising from the fact that PAC will no longer receive contractually agreed payments from Rothesay in relation to administration costs for the Transferring Business upon the implementation of the Scheme.

- A reduction in Own Funds arising from an agreement that the PAC Shareholder-Backed Business will make a £24 million payment to the PAC With-Profits Fund upon the implementation of the Scheme to compensate it for three years of increased fixed cost allocations arising from the reallocation of fixed costs described above.

- A reduction in Own Funds arising from a provision that will be established in the PAC Shareholder-Backed Business upon the implementation of the Scheme representing the value of additional support that may be provided by the PAC Shareholder-Backed Business to the PAC With-Profits Fund in due course to compensate it for an increased allocation of fixed costs after three years.
- An increase in Own Funds arising from a provision established in the PAC Shareholder-Backed Business at 31 December 2020 representing the approximate negative financial impact on the Own Funds of the PAC Shareholder-Backed Business expected to arise upon the implementation of the Scheme (as in the absence of such a provision the impact of the implementation of the Scheme would be expected to be negative to Own Funds). When the transfer takes place this provision can be released, largely offsetting the negative expected Own Funds impact..

9.11 The expected £137 million reduction in SCR reflects the following effects:

- A reduction in the SCR reflecting PAC's estimate of the reduction in the Solvency II capital requirement arising from the implementation of the Scheme as a result of the cancellation of the Reinsurance Agreement for the Transferring Business.
- A reduction in the SCR as a result of the reduction in future expenses allocated to the PAC Shareholder-Backed Business following the transfer, as described in paragraph 9.10.
- An increase in the SCR related to the provision that will be established in the PAC Shareholder-Backed Business upon the implementation of the Scheme to reflect potential additional support to the PAC With-Profits Fund, as described in paragraph 9.10.

9.12 The impact of the Scheme on PAC's consolidated regulatory solvency position at 31 December 2020 is a smaller increase in SCR Coverage Ratio compared to the impact on the PAC Shareholder-Backed Business's position because the SCR in the consolidated presentation is larger than in the PAC Shareholder-Backed Business presentation, so a £130 million increase in excess Own Funds represents a smaller change in percentage terms.

Security of benefits of policies in the PAC With-Profits Fund

9.13 Table 9.2 below shows the pro forma post-Scheme financial strength of the PAC With-Profits Fund as at 31 December 2020 on a Solvency II Pillar 1 basis.

TABLE 9.2 – THE PAC WITH-PROFITS FUND PRE-TRANSFER AND PROJECTED POST-TRANSFER SOLVENCY POSITION AS AT 31 DECEMBER 2020

	PAC With-Profits Fund, pre-Scheme	PAC With-Profits Fund, post-Scheme	Impact of Scheme
	£m	£m	£m
Solvency II Assets (net of other items)	136,163	136,187	*24*
Technical Provisions (including TMTP)	124,267	124,278	*11*
Own Funds (A)	**11,896**	**11,909**	***13***
SCR (B)	4,895	4,900	*5*
Excess Capital (=A-B)	7,001	7,009	*8*
SCR Coverage Ratio (A/B)	***243%***	***243%***	***-***

Totals/differences may not be additive due to rounding

9.14 The expected increase in Own Funds of £13 million as at 31 December 2020 is composed of a number of offsetting effects which are described in paragraph 9.10, namely:

- A reduction in Own Funds arising from the increased allocation of fixed costs to the PAC With-Profits Fund following the implementation of the Scheme.
- An increase in Own Funds arising from the expected £24 million payment to the PAC With-Profits Fund from the PAC Shareholder-Backed Business upon the implementation of the Scheme.
- An increase in Own Funds arising from the expectation of additional support from the PAC Shareholder-Backed Business beyond the three year period.

9.15 The expected increase of £5 million to the SCR of the PAC With-Profits Fund as a result of the implementation of the Scheme arises because of the extra fixed costs allocated to the PAC With-Profits Fund after the transfer, which have a knock-on impact on the SCR.

9.16 The net impact of the Scheme on the excess Own Funds of the PAC With-Profits Fund is expected to be £8 million, which is small enough that the SCR Coverage Ratio of the PAC With-Profits Fund would remain at 243% at 31 December 2020.

Longer-term capital management implications of the Scheme

9.17 I have not identified any areas where the implementation of the Scheme would have a material impact on longer-term capital management implications for PAC of the nature described in paragraphs 8.89 to 8.96. In particular:

- The transfer has a relatively small impact on PAC's SCR Coverage Ratio and therefore the transfer would not be expected to result in material changes to PAC's capital needs over the longer term;
- The transfer will not remove or reduce the extent to which PAC is able to take action to manage its solvency position should the need arise; and
- Other than the reduction in PAC's exposure to the risk of Rothesay defaulting on its obligations under the Reinsurance Agreement, the transfer will not result in a change in the profile of risks to which PAC is exposed.

Conclusions in relation to security of benefits of non-transferring policyholders of PAC

9.18 Given:

- The relatively small impact of the Scheme on the PAC Shareholder-Backed Business's regulatory solvency position;
- The relatively small impact of the Scheme on the PAC With-Profits Fund's regulatory solvency position;
- The fact that the Scheme would not cause PAC to breach the buffer required by the PAC SRA; and
- The fact that the Scheme is not expected to result in changes to the resilience level required by PAC's SRA,

I am satisfied that the transfer would not have a material adverse impact on the security of benefits of the non-transferring policyholders of PAC.

9.19 In addition, there are number of subsidiaries of PAC which may look to PAC for capital support, noting that PAC is not legally obliged to provide capital support to subsidiaries in difficulty. As the proposed transfer is expected to lead to a small increase in PAC's SCR Coverage Ratio, it will not have a material adverse effect on the level of support that PAC is able to offer its subsidiaries.

9.20 It should be noted that the financial information in Table 9.1 does not reflect the estimated impact of the planned Part VII transfer of the business written by PAC through its joint venture with the Discovery Group to Vitality Life Limited (described in paragraphs 5.36 and 5.37). As stated in paragraph 5.38, PAC has informed me that the impact of that transfer on PAC's Solvency II financial position will be negligible, and I am satisfied that my conclusions are unaffected by this transfer.

Approvals under Solvency II

9.21 The Reinsurance Agreement resulted in a material change in PAC's risk profile, and therefore the PAC TMTP was recalculated as at 31 March 2018 and this recalculation was approved by the PRA[102]. I understand that the financial impact of the Scheme on PAC, as set out in Table 9.1, is not sufficiently material in isolation to trigger a recalculation of PAC's TMTP under PAC's policy on TMTP recalculations, and therefore it is not expected that PAC's TMTP will be recalculated as a result of the implementation of the Scheme.

9.22 I am satisfied that the Scheme will not have a material impact on the regulatory approvals granted to PAC that are relevant to its financial strength, and I am therefore satisfied that the approvals assumed in calculating the pro forma post-Scheme financial position of PAC in Table 9.1 above are reasonable.

The profile of risks to which the non-transferring policies of PAC are exposed

9.23 The dominant risks for PAC are market risks, credit risk, longevity risk, expense risk and persistency risk.

9.24 As the vast majority of the risks associated with the Transferring Business have already been transferred to Rothesay through the Reinsurance Agreement, following the implementation of the Scheme, the non-transferring PAC policies will largely be exposed to the same key risk types as currently.

9.25 However, the Scheme will also reduce PAC's exposure to counterparty default risk as a result of the removal of the Transferring Business from the scope of the Reinsurance Agreement. Nonetheless, PAC's net counterparty default risk exposure to Rothesay is currently small, as the majority of the risk to PAC is mitigated by the presence of collateral accounts for the Reinsurance Agreement with Rothesay. In addition, PAC holds capital requirements in relation to the residual counterparty default risk, determined in accordance with its approved internal model. This reduction in counterparty default risk can be seen in the decrease in SCR in the pro forma post Scheme figures shown in Table 9.1. Following the implementation of the Scheme, PAC will retain some counterparty default exposure to Rothesay as a result of the continuing reinsurance of the Non-Transferring Reinsured Policies (and any Excluded Policies), as described in paragraphs 7.20 and 7.17. There will continue to be a collateral arrangement in place between Rothesay and PAC to mitigate most of the counterparty default risk in respect of the continuing reinsurance, and PAC will continue to hold an appropriate level of capital to cover any residual counterparty default risk, as determined by its approved internal model.

9.26 The policyholders of the PAC With-Profits Fund are exposed to contagion risk from the PAC Shareholder-Backed Business. In particular, in extreme circumstances (for example, if PAC became insolvent) the ring-fencing arrangements of the with-profits sub-funds within the PAC With-Profits Fund could break down and the assets of the PAC With-Profits Fund may become available to meet all of PAC's obligations. Therefore, in the event that the financial position of the PAC Shareholder-Backed Business deteriorated extremely severely, the policyholders of the PAC With-Profits Fund would no longer be insulated from the risks of the PAC Shareholder-Backed Business and it is possible that the assets of the PAC With-Profits Fund could be used to meet the obligations of the PAC Shareholder-Backed Business. However, given that the implementation of the Scheme is expected to increase the SCR Coverage Ratio of the PAC Shareholder-Backed Business, I have no reason to believe that implementation of the Scheme will increase the exposure of the non-transferring policies in the PAC With-Profits Fund to this contagion risk.

9.27 The policyholders of PAC outside its ring-fenced with-profits sub-funds are exposed to contagion risk, i.e. in the unlikely circumstance that one or more of the with-profits sub-funds of the PAC With-Profits Fund were unable to meet their liabilities, that sub-fund would be entitled to capital support from the PAC Shareholder-Backed Business. However,

[102] In addition to the scheduled biennial recalculation (see paragraph 4.40) at 31 December 2019, further ad hoc recalculations of PAC's TMTP took place as at 31 December 2018, 30 September 2019 and 31 March 2020.

implementation of the Scheme will have a minimal impact on the SCR coverage of the PAC With-Profits Fund, and will not materially affect the level of this contagion risk.

9.28 In conclusion I am satisfied that the impact of the implementation of the Scheme on the profile of risks to which the non-transferring policies of PAC will be exposed will not have a material adverse effect on the security of benefits under these policies.

THE REASONABLE EXPECTATIONS OF THE NON-TRANSFERRING POLICYHOLDERS IN PAC

9.29 The non-transferring policies of PAC comprise non-profit and with-profits policies, including linked and non-linked policies. All contractually guaranteed benefits will be unaffected by the Scheme. Policyholders' reasonable expectations in respect of their policies are principally that:

- Their reasonable benefit expectations are met. In particular, any discretionary benefits payable under their policies, and discretionary charges levied on their policies, are determined consistently with the requirement to treat customers fairly and, in relation to with-profits policies, with any governing principles and practices, such as the relevant Principles and Practices of Financial Management ("**PPFM**") document.
- The administration, management, and governance of the policies are in line with the contractual terms under the policies, and policyholders receive a good standard of service.

The governance, management and service standards applicable to the non-transferring policies of PAC

9.30 There will be no change to the operation of PAC as a result of the Scheme. In particular:

- The non-transferring policies of PAC will continue to be serviced and administered under the same arrangements and will therefore not experience any change to service standards[103]; and
- The governance of the non-transferring policies will continue to be the responsibility of the PAC Board with additional oversight, in the case of the non-transferring policyholders in the PAC With-Profits Fund, of the PAC With-Profits Committee.

9.31 Hence I am satisfied that the implementation of the Scheme will not have a material effect on the governance, management and service standards of the non-transferring policies of PAC.

The reasonable benefit expectations of non-transferring policyholders of PAC

Existing policyholders of the PAC With-Profits Fund

9.32 In relation to the existing policies in the PAC With-Profits Fund, the implementation of the Scheme will not lead to any changes in the operation of the PAC With-Profits Fund. In particular, the implementation of the Scheme will not change:

- The terms and conditions of the PAC With-Profits Fund policies;
- The charges that apply to the policies of the PAC With-Profits Fund;
- The principles and practices used in the management of the PAC With-Profits Fund;
- The methodology used to calculate asset shares and surrender values for with-profits policies of the PAC With-Profits Fund; or
- The bonus and pay-out policies applied to the with-profits policies of the PAC With-Profits Fund.

and so it will not affect the reasonable expectations of holders of policies in the fund directly.

[103] PAC does not expect that the proposed agreement between Rothesay and PAC regarding the administration of Transferring Policies after the Transfer Date (see paragraph 7.38) will place any additional contractual restrictions on PAC in relation to its outsourcing arrangements for the non-transferring policies.

9.33 There will be no changes to the terms and conditions of the existing policies of the PAC With-Profits Fund or to the PPFM. The existing policies of the PAC With-Profits Fund will remain in the PAC With-Profits Fund after the implementation of the Scheme.

9.34 I understand that a small number[104] of Transferring Policies' benefits were moved from the PAC WPSF to the PAC NPSF in order to maintain policy integrity for the transfer. The PAC WPA has stated in his report on the Scheme that the terms on which these benefits were reallocated to the PAC NPSF were reviewed to ensure that they were fair and reasonable. Given the small benefit value concerned in the context of the large size of the PAC WPSF, I am comfortable relying on the statement of the PAC WPA in this regard.

9.35 As a result of the implementation of the Scheme, some of the business of the PAC NPSF will be transferred to Rothesay. As described in paragraph 9.10, this results in a relative increase in the size of the PAC WPSF compared to the NPSF, which in turn will mean that a higher proportion of PAC's fixed costs (including annuity administration expenses) will be allocated to the PAC WPSF as a result of the implementation of the Scheme. In the absence of any remedial action, this will result in approximately £8 million p.a. of additional costs being allocated to the PAC WPSF from the point at which administration of the Transferring Policies is transferred to Rothesay's chosen administration provider. However, as described in paragraph 9.10, PAC has informed me that the PAC Shareholder-Backed Business will make a payment, currently expected to be £24 million, to the PAC WPSF to compensate it for the first three years of increased cost allocations. Following the end of this three year period, a review will be undertaken to establish whether any further compensation is needed to ensure that holders of policies in the PAC WPSF are not materially disadvantaged by the proposed transfer; this will take into account the benefit to the PAC WPSF of any reduction in the overall level of PAC's administration costs. I understand that the PAC WPA and the PAC With-Profits Committee are satisfied with the proposed compensation arrangements, subject to appropriate documentation being put in place prior to the 2021 Sanction Hearing. I am also satisfied that the proposed arrangements are fair and, if implemented, will not have a material adverse effect on the reasonable benefit expectations of holders of policies in the PAC With-Profits Fund. I will consider the formalisation of these arrangements in my 2021 Supplementary Report.

9.36 As discussed in paragraph 7.37, some of PAC's policies, including the Transferring Policies, are administered by TCS/Diligenta. The agreement with TCS/ Diligenta includes clauses that require PAC to pay compensation if PAC makes changes to its business which results in business covered by the agreement being transferred away from TCS/ Diligenta.

9.37 The proposed transfer and the associated changes to future administration arrangements of the Transferring Policies are not sufficient to trigger the compensation clauses. Furthermore, since the Transferring Policies are all part of the PAC Shareholder-Backed Business, if they were to trigger the compensation clause then the charge would be met in full by the PAC SHF. However, the compensation clauses are based on cumulative changes and therefore the proposed transfer increases the likelihood of the threshold being breached in the event of future transfers from the PAC With-Profits Fund.

9.38 I understand that any compensation would be allocated against all transfers that had contributed to the triggering of the compensation clause, irrespective of which transfer had actually resulted in the trigger amount being breached. The PAC WPA has concluded in his report on the Scheme that the PAC WPSF will not incur any material additional costs in relation to such compensation, and I agree with this analysis. I am therefore satisfied that the increased likelihood of triggering the TCS/Diligenta compensation clauses does not have a material adverse impact on the reasonable benefit expectations of the existing policyholders of the PAC WPSF.

9.39 PAC's consolidated SCR Coverage Ratio is expected to increase as a result of the implementation of the Scheme, but as described in paragraph 9.16, the PAC With-Profits Fund's SCR Coverage Ratio is expected to remain broadly unchanged as a result of the transfer.

9.40 None of the costs associated with the Scheme will be borne by the PAC With-Profits Fund.

[104] 181 annuity policies were transferred from the PAC WPSF to PAC NPSF. This corresponds to £740,000 in annual annuity payments.

9.41 Hence I am satisfied that the implementation of the Scheme will not have a material effect on the reasonable benefit expectations of the policyholders of the PAC With-Profits Fund.

The existing policies in the PAC SHF and PAC NPSF

9.42 The PAC NPSF business is non-profit in nature (including linked and non-linked business), and the business of the PAC SHF comprises claims in payment on general insurance business and, as such, policyholders' reasonable benefit expectations are that:

- Any discretionary benefits are fair, and consistent with current practice;
- Policyholders have access to the same range of funds and investment expertise (for linked business); and
- The level of charges (for linked business) is reasonable and in line with information provided to policyholders;

9.43 There will be no changes arising from the Scheme to the terms and conditions of the existing PAC SHF and PAC NPSF policies or to discretionary aspects of policies such as applicable charges. The existing policies in the PAC SHF and PAC NPSF will remain in the PAC SHF and PAC NPSF respectively after the implementation of the Scheme.

9.44 There will be no reduction in the range of funds or change to the investment expertise that the existing unit-linked policies of PAC are able to access as a result of the Scheme.

9.45 The PAC NPSF includes some premium-paying policies where the level of premiums is subject to regular review and may be revised in light of emerging experience. PAC has informed me that the proposed transfer will have no impact on the outcome of these premium reviews.

9.46 I also note that, as described in paragraph 7.11, the Transferring Business has been formulated in such a way to ensure that no policy benefits will be split between PAC and Rothesay.

9.47 Hence I am satisfied that the implementation of the Scheme will not have a material effect on the reasonable benefit expectations of the policyholders of PAC's SHF and NPSF.

Conclusions in relation to the reasonable expectations of the non-transferring PAC policyholders

9.48 Taking into account my conclusions in paragraphs 9.31, 9.41 and 9.47, I am satisfied that the implementation of the Scheme will not have a material adverse impact on the reasonable expectations of the non-transferring PAC policyholders.

CONCLUSION FOR THE NON-TRANSFERRING POLICIES IN PAC

9.49 Overall, I am satisfied that the implementation of the Scheme will not have a material effect on:

- The security of benefits of the non-transferring policies of PAC; or
- The reasonable expectations of holders of non-transferring policies of PAC, including:
  - The reasonable benefit expectations of holders of non-transferring policies of PAC; and
  - The standards of service, management and governance applicable to non-transferring policies of PAC.

9.50 For the avoidance of doubt, my conclusions in relation to the non-transferring policies of PAC apply equally to PIA in its capacity as a cedant to PAC under the reinsurance arrangements described in paragraph 5.33.

10. The Effect of the Implementation of the Scheme on the Existing Policies of Rothesay

INTRODUCTION

10.1 In this section I consider the effect of the implementation of the Scheme on the existing Rothesay policies.

10.2 For these policies, I consider the likely effects of the implementation of the Scheme on the security of the guaranteed benefits and on the benefit expectations of the holders of those policies.

10.3 The key issues to consider are:

- The financial resources available to provide security for the benefits of the existing Rothesay policyholders after the implementation of the Scheme compared to those currently available;
- The effect on the existing Rothesay policies of any change in the risk profile of Rothesay as a result of the implementation of the Scheme; and
- The effect of the implementation of the Scheme on the reasonable expectations of the existing Rothesay policyholders.

THE FINANCIAL RESOURCES AVAILABLE TO PROVIDE SECURITY OF BENEFITS

10.4 Rothesay's capital management policy, which sets out a target level of capital buffer that Rothesay holds in excess of regulatory requirements, will not be changed by the implementation of the Scheme, and so the security of existing policyholder benefits will only be affected by any changes to the company's ability to comply with this policy.

10.5 Currently, security for the guaranteed benefits of the existing policyholders of Rothesay is provided by:

- The assets in Rothesay backing the Technical Provisions held to meet the guaranteed benefits of the existing Rothesay policies;
- The assets backing the SCR of Rothesay; and
- Excess capital resources in Rothesay.

10.6 After the implementation of the Scheme, the security of the guaranteed benefits of the existing and transferring policyholders in Rothesay will continue to be provided by these three elements, albeit that Rothesay's assets will include the transferring longevity reinsurance treaties listed in Table 7.2.

10.7 Upon the implementation of the Scheme, the assets held in the custody accounts in relation to the Transferring Business will also be released, which will mean Rothesay is no longer bound by the contractual constraints on the investment strategy for these assets contained in the Reinsurance Agreement. This means Rothesay may elect to invest those assets differently to the way in which they are currently invested; however, any changes to the investments held will be required to comply with the relevant regulations, including the Prudent Person Principle, and to the extent that the assets are held in Rothesay's Matching Adjustment Portfolio they will need to comply with the relevant eligibility conditions of Rothesay's Matching Adjustment approval.

10.8 The implementation of the Scheme will have no impact on the Technical Provisions held in relation to the current Rothesay policies (save to the extent that any change to the mix of investments released from the custody accounts results in a change to Rothesay's Matching Adjustment). It should be noted that the assets held in the custody accounts for the Transferring Policies will be released from the security arrangements while the Non-Transferring Reinsured Policies and the Excluded Policies will continue to be reinsured by Rothesay Life on a long term basis under a modified version of the Reinsurance Agreement.

10.9 The following table shows Rothesay's Solvency II financial position as at 31 December 2020, both before and (on a pro forma basis) after implementation of the Scheme.

TABLE 10.1: ROTHESAY SOLVENCY II PILLAR 1 BASIS BALANCE SHEET AS AT 31 DECEMBER 2020

	Rothesay pre-Scheme	Rothesay post-Scheme	Impact of Scheme
	£m	£m	£m
Solvency II Assets (net of other items)	61,742	61,742	-
Technical Provisions (including TMTP)	54,389	54,389	-
Own Funds	**7,353**	**7,353**	**-**
SCR	3,623	3,623	-
Excess Capital	3,730	3,730	-
SCR Coverage Ratio	***203%***	***203%***	**-**

10.10 The table shows that if the Scheme had been effective as at 31 December 2020 there would have been no change to the excess assets in Rothesay as the Transferring Policies are already reinsured to Rothesay and the transaction was fully funded at outset. Thus Rothesay would have remained in a strong financial position relative to its minimum required capitalisation under its capital management policy.

10.11 It should be noted that the post-Scheme estimate of Rothesay's financial position is, in practice, likely to be slightly prudent as Rothesay expects to incur lower costs for the administration of the Transferring Business once it has transferred this administration to its own provider(s); this cost benefit has not been reflected in the post-Scheme financial position.

10.12 I am satisfied that the implementation of the Scheme will not have a material adverse effect on the financial strength of Rothesay, and hence on the security of the benefits of the existing Rothesay policies.

APPROVALS UNDER SOLVENCY II

10.13 As discussed in paragraphs 6.29 and 6.30, Rothesay has received approval from the PRA to use the Matching Adjustment, the TMTP and a PIM.

10.14 The Reinsurance Agreement resulted in a material change in risk profile and therefore the Rothesay TMTP was recalculated by Rothesay and approved by the PRA with effect from 14 March 2018[105]. As the implementation of the Scheme will not result in a further material change in risk profile, the TMTP will not be recalculated as a result of the Scheme in isolation, although Rothesay may undertake future ad hoc recalculations of its TMTP for other reasons, in accordance with its policy on TMTP recalculations.

10.15 As described above, to the extent that Rothesay elects to invest the assets released from the custody accounts in a manner that would not have been permitted under the constraints imposed by the Reinsurance Agreement, this may affect the size of Rothesay's Matching Adjustment. Any of the assets that are not eligible to be included in Rothesay's Matching Adjustment portfolio would be held outside of the Matching Adjustment Portfolio. Rothesay has confirmed to me that it does not intend to invest the assets released from the custody accounts in a materially different way following the implementation of the Scheme.

10.16 I am satisfied that the Scheme will not have a material impact on the PRA approvals granted to Rothesay, and I am therefore satisfied that the approvals assumed in determining the pro forma post-Scheme financial position of Rothesay in Table 10.1 above are reasonable. I will comment on any changes to Rothesay's Solvency II approvals and their impact on the financial position of Rothesay in my 2021 Supplementary Report.

[105] In addition to the scheduled biennial recalculation (described in paragraph 4.40) as at 31 December 2019, Rothesay's TMTP was subject to an ad hoc recalculation as at 31 December 2020.

PRIORITY OF DIRECT POLICYHOLDERS RELATIVE TO INWARD REINSURANCE

10.17 Before the implementation of the Scheme, the Transferring Policies remain policies of PAC. After the proposed transfer, the Transferring Policies will become direct policies of Rothesay rather than being treated as inward reinsurance business. Typically, inward reinsurance business would rank below direct policies in terms of priority over assets in the event of insolvency. However, a charge has been put in place under the terms of the Reinsurance Agreement, such that PAC (as the cedant) would have recourse to the assets secured in the custody accounts in the event of certain Rothesay default events occurring (including Rothesay's insolvency).

10.18 Therefore, in an extreme scenario in which Rothesay becomes insolvent, the presence of the custody arrangements will dilute the assets available to Rothesay policyholders. By reducing the size of the custody accounts, implementation of the Scheme will reduce the level of dilution and have a beneficial effect on existing Rothesay policyholders' benefit security.

THE PROFILE OF RISKS TO WHICH THE EXISTING ROTHESAY POLICIES ARE EXPOSED

10.19 The Reinsurance Agreement has increased the absolute levels of longevity risk and credit risk in Rothesay. However, since the transfer of these risks from PAC to Rothesay has already occurred through the operation of the Reinsurance Agreement, the implementation of the Scheme will not add to these risks.

10.20 Under the Scheme, Rothesay will also assume some residual liabilities in relation to potential future mis-selling claims from Transferring Policyholders, as described in paragraph 7.33. However, under the terms of the Business Transfer Agreement, these liabilities will transfer to Rothesay even if the Scheme is not sanctioned, via an indemnity provided to PAC by Rothesay. Therefore I have not considered the impact of this transfer of mis-selling liabilities as the economic risk associated with these liabilities will transfer to Rothesay regardless of whether the Scheme is implemented. For the avoidance of doubt, any liabilities (current or future) related to PAC's TRASP PBR will remain with PAC.

10.21 In conclusion I am satisfied that the impact of the implementation of the Scheme on the profile of risks to which the existing Rothesay policies will be exposed will not have a material adverse effect on the security of benefits under these policies.

THE REASONABLE EXPECTATIONS OF THE EXISTING ROTHESAY POLICYHOLDERS

10.22 As discussed in Section 6, Rothesay's long-term insurance business comprises:

- Bulk purchase annuity contracts to trustees of UK defined benefit pension schemes by way of a buy-in policy;
- Individual policies to former members of UK defined benefit pension schemes as a consequence of a buy-out of their benefits by Rothesay and individual policies acquired from other UK insurers; and
- Longevity insurance (also known as longevity reinsurance contracts or longevity swaps) provided to UK defined benefit pension schemes.

10.23 In particular, Rothesay does not have discretion over the amounts payable to its policyholders with the exception of the discretion it has to determine commutation values for policyholders who wish to exchange part of their pension income for a lump sum. Policyholders' reasonable benefit expectations under such products are therefore that:

- Policyholders who elect to commute part of their future pension income receive an amount that is fair compensation for the pension income being forgone; and
- The administration, servicing, management, and governance of the policies are in line with the contractual terms of the policies and regulatory and legal requirements.

10.24 As described in paragraph 10.12 above, I am satisfied that the implementation of the Scheme will not have a material adverse impact on the security of benefits under the existing Rothesay policies. Rothesay's management has also informed me that the implementation of the Scheme will not affect the approach to commutation of future pension income. I am therefore satisfied that the implementation of the Scheme will not have a material effect on the reasonable benefit expectations of the existing Rothesay policyholders.

The governance, management and service standards applicable to the existing Rothesay policies

10.25 The Scheme will not alter the terms and conditions of existing policies in Rothesay.

10.26 The implementation of the Scheme will not lead to any changes to the servicing and administration arrangements and existing Rothesay policies will continue to be serviced by Mercer, Capita and Willis Towers Watson (with appropriate oversight by a dedicated operations team at Rothesay) as described in paragraphs 6.53 and 6.54.

10.27 As described in paragraph 8.162, PAC and Rothesay have agreed a TSA that will come into force upon the implementation of the Scheme, under which PAC will continue to provide administration services for the Transferring Policies (provided by TCS/Diligenta on its behalf) for a period of 6 to 12 months after the Transfer Date. The administration of the Transferring Policies will, therefore, be carried out separately from the administration of Rothesay's existing policies initially, and so the proposed transfer will have no effect on the administration arrangements of the existing policies of Rothesay. During this period, Rothesay will put into effect a transfer of the administration arrangements applicable to the Transferring Business to an administration provider of its choice.

10.28 Rothesay has assured me that it has access to a sufficient level of suitably experienced resources to ensure that the transfer of the administration arrangements applicable to the Transferring Business does not adversely affect the oversight of the administration of Rothesay's existing policies, and the presence of the TSA should help to ensure that this is the case. I also note that Rothesay's business model involves frequent exercises in which administration arrangements are put in place for new policies without adversely affecting existing policies (and typically without the benefit of a TSA).

10.29 The governance of the existing non-profit policies will continue to be the responsibility of the Rothesay Board.

10.30 Taking the above into account, I am satisfied that the implementation of the Scheme will not have a material adverse effect on the standards of governance, management and service applicable to the existing Rothesay policies.

Conclusions in relation to reasonable expectations

10.31 Taking into account the conclusions in paragraphs 10.24 and 10.30, I am satisfied that the implementation of the Scheme will not have a material adverse effect on the reasonable expectations of existing Rothesay policyholders.

CONCLUSIONS

10.32 Overall, I am satisfied that the implementation of the Scheme will not have a material effect on:

- The security of benefits of the existing policyholders of Rothesay; or
- The reasonable expectations of the existing policyholders of Rothesay, including:
    - The reasonable benefit expectations of existing policyholders of Rothesay; and
    - The standards of service, management and governance applicable to the existing Rothesay policies.

11. Consideration of the Reinsurance Agreement

CONSIDERATION OF THE COMBINED IMPACT OF THE REINSURANCE AGREEMENT AND THE SCHEME

11.1 In preparing my Report, I have considered the impact of the Scheme in isolation on the various categories of policies. This reflects the fact that the Reinsurance Agreement is already in place and is expected to remain in force whether or not the Scheme is approved by the Court.

11.2 However, the purpose of the Scheme is to complete the agreement to transfer the Transferring Policies to Rothesay as set out in the Business Transfer Agreement. As described in paragraph 7.2, the Companies first implemented the Reinsurance Agreement as an interim step, which transferred substantially all of the economic risk and reward of the Reinsured Business to Rothesay and which required PRA non-objection but not Court approval. The Companies now seek the sanction of the Scheme by the Court to formally transfer the Transferring Policies to Rothesay in accordance with the process set out in the Business Transfer Agreement. In addition to considering the proposed transfer in isolation, it is relevant for me to consider the overall effect of this transaction on each group of policyholders.

11.3 For the non-transferring policies of PAC (including the Non-Transferring Reinsured Policies), the effect of the Reinsurance Agreement was to reduce the risks and associated capital requirements in PAC. That is, while the Scheme itself results in a small improvement in the solvency position of PAC, the implementation of the Reinsurance Agreement led to a material improvement in the solvency position of PAC[106]. Therefore considering the combined impact of the Reinsurance Agreement and the Scheme would have presented a more compelling picture, in terms of the improvement in the financial resources available to provide security of benefits for the non-transferring PAC policyholders, than the one discussed in the rest of this Report. I would not have altered my conclusions in respect of these policies.

11.4 For the existing Rothesay policies, the Reinsurance Agreement in isolation resulted in a deterioration of Rothesay's capital position because the reinsurance premium received by Rothesay was lower than the increase in Rothesay's Technical Provisions and SCR that resulted from its implementation. However, it also resulted in an increase in Rothesay's TMTP (which offsets part of the increase in capital requirements), and Rothesay raised additional capital from its shareholders to support its ability to execute the transaction. This meant that, overall, the Reinsurance Agreement did not have a material impact on Rothesay's solvency position. As discussed in paragraph 8.28, I have reviewed projections showing the effect of the TMTP run-off on Rothesay's solvency position; they demonstrate that the future run-off of the TMTP is expected to be more than offset by the emergence of future surplus on the business that is subject to the TMTP; this analysis is based on Rothesay's position after the implementation of the Reinsurance Agreement.

11.5 Given that there was no material change in the SCR Coverage Ratio of Rothesay as a net result of the Reinsurance Agreement, the TMTP recalculation and the additional capital raised by Rothesay, comparison of the "pre-Scheme, pre-Reinsurance Agreement" and "post-Scheme, post-Reinsurance Agreement" solvency positions of Rothesay has not altered my conclusions regarding the impact of the Scheme on the Rothesay policies.

11.6 For the Transferring Policies, I have not been provided with a precise estimate of what the PAC Solvency II financial position would be as at 31 December 2020 if the Reinsurance Agreement was not in place, but PAC has informed me that its SCR Coverage Ratio would be significantly lower in the absence of the Reinsurance Agreement owing to the increase in its Risk Margin and SCR that would result from recapturing the risks reinsured to Rothesay; a significantly lower SCR Coverage Ratio is consistent with my expectations. The SCR Coverage Ratio of Rothesay, which is relevant for the Transferring Policies once the Scheme takes effect, was materially unchanged as a result of the Reinsurance Agreement due to the associated capital injection and TMTP recalculation. The combination of the Reinsurance Agreement and the Scheme would have therefore led to a more pronounced increase in SCR Coverage Ratio (and therefore financial strength) for the Transferring Policies than the Scheme in isolation.

[106] This arose because the premium paid to Rothesay under the Reinsurance Agreement was lower than the combined value of the resulting reinsurance asset and the reduction in the Risk Margin and SCR of PAC that the transfer of risk to Rothesay brought about.

11.7 As described in paragraph 7.33, a consequence of the Business Transfer Agreement is that certain residual mis-selling risks associated with the Transferring Business will transfer to Rothesay from PAC. This transfer of mis-selling risks is not a consequence of the Scheme as it will take place regardless of whether the Scheme is implemented, but it is a consequence of the overall transaction between PAC and Rothesay. The nature of potential mis-selling liabilities is such that it is not possible reliably to estimate the size of any such liabilities; instead it is necessary for an insurer agreeing to take on such liabilities to understand and interrogate the way in which the relevant business was originated and the risks associated with that origination process. At the time of the inception of the Reinsurance Agreement, Rothesay undertook due diligence on the Reinsured Business, and took comfort from the following:

- For bulk annuity business (Category 4 in Table 7.1), the pension scheme trustees entering into such contracts are normally professionally advised, and the benefits provided by the insurer are typically a direct replacement of the pension scheme's liabilities, which means that the scope for credible mis-selling claims to be brought against PAC (or subsequently Rothesay) was deemed to be very small.

- For retail annuity business (Categories 1, 2 and 3 in Table 7.1), PAC has completed its TRASP PBR (see paragraph 7.28) and Rothesay will not assume any mis-selling liabilities unless such liabilities crystallise after 31 December 2026. Given the nature of the TRASP PBR and the time elapsed between the purchase of the annuity and the date on which Rothesay will assume the mis-selling risk, Rothesay deemed the mis-selling risk to which it is exposed on the Transferring Policies belonging to Categories 1, 2 and 3 to be negligible.

11.8 Rothesay therefore considers that its risk exposure arising from the Transferring Policies' mis-selling liabilities is not material, and I agree with this assessment.

11.9 Accordingly, including the effect of the Reinsurance Agreement in my considerations would not have altered my conclusions on the impact of the Scheme on the Transferring Policies.

11.10 The Reinsurance Agreement had no impact on reasonable benefit expectations of holders of the Transferring Policies, non-transferring PAC policies or the existing Rothesay policies. In addition the Reinsurance Agreement had no impact on the service standards and governance applicable to Transferring Policies, non-transferring PAC policies or existing Rothesay policies. Therefore, considering the combined impact of the Reinsurance Agreement and the Scheme on these issues has not altered my conclusions on policyholder's reasonable benefit expectations or the service standards and governance applicable to policies (which are discussed in Sections 8, 9 and 10).

11.11 Overall, I am satisfied that my conclusions would not have been different had I considered the combined impact of the Reinsurance Agreement and the Scheme.

CONSIDERATION OF THE REINSURANCE AGREEMENT IF THE SCHEME IS NOT SANCTIONED

Consideration if the Reinsurance Agreement remains in place for Transferring Policies

11.12 If the Scheme does not proceed to completion as intended, the Reinsurance Agreement will remain in place unless terminated by PAC[107]. It is the current expectation of PAC that the Reinsurance Agreement will not be terminated in this event and so the Transferring Business will remain reinsured to Rothesay.

11.13 As outlined in paragraphs 11.3 and 11.4, the implementation of the Reinsurance Agreement led to a material increase in the SCR Coverage Ratio of PAC and had no material impact on Rothesay's solvency position, after allowing for the recalculation of Rothesay's TMTP and for the capital raised by Rothesay to support the transaction (described in paragraph 11.4). Additionally, the custody accounts established as part of the reinsurance arrangement provide extra security to all of the PAC policyholders, including but not limited to the policyholders who would have transferred under the Scheme.

[107] As described in paragraph 6.22, Rothesay also has the right to require recapture of the reinsurance by PAC in certain, limited circumstances, examples of which are given in paragraph 11.26.

11.14 PAC and Rothesay submitted evidence to the Court during the 2019 Sanction Hearing setting out reasons why the non-sanction of the Scheme and the continuation of the Reinsurance Agreement for Transferring Policies would impose costs (both actual costs and opportunity costs) and additional risks upon them.

11.15 In PAC's case, the reasons can be summarised as:

- The continuation of the Reinsurance Agreement for Transferring Policies would mean that PAC would be required to continue to hold capital requirements against the risk that Rothesay fails to meet its obligations under this agreement. This addition to PAC's capital requirement has been estimated as approximately £130 million, and represents an opportunity cost to PAC as it is unable to use that capital to invest in ventures that could earn a significant return in excess of risk-free yields for its shareholders.

- The continuation of the Reinsurance Agreement for Transferring Policies would mean that the collateral structure required by the agreement would remain in place, which would result in PAC incurring additional costs because it would need to allocate resources to maintain oversight of the collateral structure.

- The non-sanction of the Scheme and the consequent continuation of the Reinsurance Agreement for Transferring Policies exposes PAC to the risk that, under certain circumstances, the Reinsurance Agreement could be terminated, which would (as described above) result in a significant capital strain for PAC, noting that this could only take place against PAC's will in a very limited range of circumstances, as described in paragraph 11.26.

11.16 I note that PAC has clarified to me that it would not expect the costs referred to in the second bullet of paragraph 11.15 to be material.

11.17 In addition to the reasons listed in paragraph 11.15, in the event that Rothesay's solvency position were to deteriorate significantly, the extent to which PAC deems it appropriate to take full credit for the risk-mitigating effect of the Reinsurance Agreement in its financial position could reduce, and in such a scenario the continuation of the Reinsurance Agreement for Transferring Policies could result in a more adverse outcome for PAC's financial position than that described in paragraph 11.15.

11.18 In Rothesay's case, the reasons why the non-sanction of the Scheme and the continuation of the Reinsurance Agreement for Transferring Policies would impose additional costs and risks upon it can be summarised as:

- The continuation of the Reinsurance Agreement for Transferring Policies would result in Rothesay being required to pay higher administration costs than it would incur if it used its own third party administrators to provide administration services. These additional costs are expected to be approximately £7.5 million p.a.

- The continuation of the Reinsurance Agreement for Transferring Policies would mean that Rothesay is required permanently to comply with the eligibility requirements associated with the collateral structure under that agreement. This means that Rothesay is not able to invest and manage the collateral assets freely. It estimates that the opportunity cost of restrictions on its ability to manage assets in a more dynamic and timely way equates to approximately £11 million p.a. on average, i.e. a loss of approximately 0.1% p.a. of return on average on the c.£11 billion of assets that relate to the Transferring Business. The presence of the collateral arrangements also limits Rothesay's ability to manage its liquidity risk efficiently, which limits the potential investment returns it could achieve.

- The continuation of the Reinsurance Agreement for Transferring Policies would restrict Rothesay's ability to manage the residual longevity risk of the Transferring Business as it would not be a party to the various longevity reinsurance arrangements between PAC and various reinsurers that apply to the Transferring Policies. In particular, any additional reinsurance of longevity risk that Rothesay wished to put in place on the Transferring Business would necessarily be subject to sub-optimal and potentially complex arrangements.

11.19 As stated above, the opportunity cost of £11 million p.a. quoted above arising from compliance with the eligibility requirements is equivalent to stating that Rothesay is forgoing approximately 0.1 percentage point p.a. on the return it could achieve on the collateral assets in the absence of the eligibility requirements; I am satisfied that this figure represents a plausible estimate of the true opportunity cost.

11.20 It should be noted that the financial benefits to Rothesay from the sanctioning of the Scheme have not been reflected in Rothesay's pro forma post-Scheme financial position, set out in Tables 8.1 and 10.1.

11.21 In my view, the reasons set out above represent plausible additional costs to the Companies arising from the non-sanction of the Scheme and continuation of the Reinsurance Agreement for Transferring Policies. Although these costs are small in the context of the liabilities of the Transferring Policies, in absolute terms they are material. For example, even under a conservative estimate, the present value of the elevated administration costs of £7.5 million p.a. and opportunity costs of £11 million p.a. over the lifetime of the Transferring Business is likely to be well in excess of £100 million.

11.22 While the Reinsurance Agreement was designed to be operable for the entire duration of the Reinsured Business, and did not treat sanction of the Scheme as a foregone conclusion, it was nevertheless expected at outset that it would only be in place temporarily for a large part of the Reinsured Business. The additional risks and operational complexity introduced by the continuation of the Reinsurance Agreement for Transferring Policies are real. In particular, the continuing application of the Reinsurance Agreement to Transferring Policies and the associated collateral requirements may restrict or slow down the extent to which the Companies can take action to manage risks. Nevertheless, while these risks are genuine, I would expect companies of the size of PAC and Rothesay to be in a position to manage the associated complexities appropriately.

11.23 Also, while PAC would be exposed to the risk that the Reinsurance Agreement could be terminated, as described in paragraph 11.26 the circumstances in which this could take place other than at PAC's instigation are limited.

11.24 As the additional costs are moderate in relation to the overall sizes of PAC and Rothesay and as it should be possible for insurers of the size of Rothesay to manage any operational complexity introduced by the continuation of the Reinsurance Agreement, I am satisfied that policyholders of both firms would not be materially adversely affected by the Reinsurance Agreement remaining in place if the Scheme were not sanctioned.

Consideration if the Reinsurance Agreement is terminated

11.25 The termination of the Reinsurance Agreement could, in almost all circumstances, only take place at PAC's instigation.

11.26 I have reviewed the list of circumstances in which Rothesay could unilaterally terminate the treaty; these include fraudulent behaviour and the insolvency[108] of PAC. I am in agreement with PAC's view that it is highly unlikely that Rothesay could be in a position to terminate the treaty unilaterally.

11.27 PAC has stated that, based on its current intentions, it would be unlikely to terminate the Reinsurance Agreement in the event that the Scheme was not sanctioned. In addition, the Reinsurance Agreement achieves the target level of capital release that PAC had sought from the sale of the Transferring Business. However, I have considered the impact on policyholders if the Reinsurance Agreement were to be terminated.

11.28 The termination payment that PAC would receive from Rothesay, and therefore the impact of termination on the financial positions of both Companies, depends on the reason for termination.

11.29 Nevertheless, it is likely to be disadvantageous to PAC's solvency position to recapture the Reinsurance Agreement in circumstances where there is no default by Rothesay, and recapture could cause PAC's solvency ratio to fall below its minimum target, as the termination payment received by PAC would be insufficient to meet the additional capital requirements it would need to hold in respect of the risks arising from the recaptured business. Thus PAC would need to consider management actions in accordance with its SRA to restore its capital position, although it would not be expected that a recapture would cause PAC's SCR Coverage Ratio to reduce below 100% even in the absence of mitigating actions. Additionally, whatever the financial impact on Rothesay of the Reinsurance Agreement, Rothesay

[108] The reference to insolvency here does not refer to a breach of PAC's SCR; instead it refers to a situation in which PAC was to be wound up (or situations comparable to this), which is a much more extreme scenario than an SCR breach.

is obliged to honour its obligations under the Reinsurance Agreement, both in financial terms and in relation to standards of service provided to PAC. For this reason I consider it to be highly unlikely that PAC would choose to effect such a recapture in the event that the Scheme is not sanctioned.

11.30 The termination of the Reinsurance Agreement would be likely to result in an improvement to Rothesay's solvency position. The extent of the improvement would depend on the amount of termination payment to be made by Rothesay, which depends in turn on the trigger for termination. Termination would allow Rothesay to return some or all of the capital raised to support the Reinsurance Agreement to its shareholders should it wish to do so. However, Rothesay would only be in a position to effect the termination of the Reinsurance Agreement if there was a default by PAC which triggered a termination right.

11.31 If the Scheme is not sanctioned it is very unlikely, in my view, that the Reinsurance Agreement would be terminated as a result of the non-sanction of the Scheme itself. As described above, such a termination could, in almost all circumstances, only take place at PAC's instigation, and would result in a significant deterioration in PAC's capital position.

12. Other Considerations arising from the Scheme

COVID-19

12.1 This Report has been prepared during the first half of 2021, at which time the COVID-19 pandemic continues to have a major effect on life in most parts of the world. The future course of the pandemic cannot be predicted with any degree of reliability.

12.2 To date, the pandemic has resulted in more than 100,000 deaths in the UK, and has, at certain times, resulted in significant economic turbulence and financial market volatility.

12.3 In common with the vast majority of similar organisations, both PAC and Rothesay have had to adapt their working arrangements and operational processes in response to the pandemic. In particular, both organisations are, at the time of writing, operating with the vast majority of their UK staff working from home, as are the third party administration providers used by the Companies to administer their policies.

12.4 The Companies have assured me that they remain in a position to fully discharge their obligations in relation to the 2021 Court Process and to implement the Scheme if it is sanctioned, even if the current operational and working conditions continue, and I have no reason to believe that this is not the case.

12.5 I have considered whether the pandemic and its effects give rise to any reasons why it would be inappropriate for the Companies to pursue the 2021 Court Process in line with the proposed timescales. In particular I have considered whether policyholders affected by the Scheme, particularly Transferring Policyholders, would be subject to any detriment by being asked to engage with the Scheme at this time. The pandemic is likely to have resulted in anxiety and distress for some, particularly those who are elderly or otherwise deemed to be clinically vulnerable, and for such people there may be limited desire or ability to fully consider a proposal to transfer their policy to another insurer. There are also practical questions to consider, such as whether the current restrictions and guidelines around social distancing and related areas represent a material impairment to the ability of policyholders to make their views known on the Scheme and/or to obtain appropriate legal representation should they wish to do so. In considering these matters, I note that:

- The details of the Scheme have been available to affected policyholders for some time, and in particular for almost a year before the onset of COVID-19;
- While it is possible that, for some policyholders, there may be particular practical difficulties associated with corresponding by post (if, for example, they do not feel comfortable leaving their homes), given that policyholders are able to make their views known on the Scheme by email or by phone, I do not believe that the current situation in relation to COVID-19 presents unreasonable practical difficulties for policyholders in making their views on the Scheme known to the Companies and to the Court;
- I am not aware of any issues associated with obtaining suitable legal representation, should any policyholders wish to do so, notwithstanding that the current situation means that face-to-face legal advice may be unavailable; and
- While it is possible that some policyholders are less able or less inclined to engage with the Scheme as a result of COVID-19, this has to be balanced against the points above, as well as the fact that it is more than two years since policyholders were first provided with information on the Scheme. Moreover, in my view it is far from certain that a further delay would reduce any disruptive effects of COVID-19 on the process, since it is not known how long restrictions to control the pandemic may persist.

12.6 Taking the above into account, I am currently satisfied that the potential impacts of COVID-19 on policyholders are not such that it would be inappropriate for the Companies to pursue the 2021 Court Process in accordance with the proposed timescales. However, I will keep this under review as the situation develops, and will comment on the up-to-date position in my 2021 Supplementary Report.

The impact of COVID-19 on the Companies' liabilities

12.7 COVID-19 has required all life and pension insurers to consider whether their assumptions regarding the future mortality rates of their policyholders are appropriate. I have sought information from the Companies on whether they expect the COVID-19 pandemic to have a significant impact on the size of their liabilities, noting that any assumption changes made prior to 2021 in response to the pandemic will already be reflected in the end-2020 financial information presented in this Report.

12.8 Neither PAC nor Rothesay has yet decided whether any changes to mortality assumptions will be required during 2021, but both Companies have plans in place to undertake a review of their assumptions. However, given the COVID-19 situation in the UK at the time of writing this Report (i.e. high vaccination take-up and very low daily deaths), I expect that any changes to mortality assumptions will largely be technical in nature (for example, decisions on the extent to which 2020 and 2021 should be excluded from historical mortality analysis on the basis that they are outliers), rather than having material impacts on the Companies' liabilities. That said, there may be future, indirect, impacts of COVID-19 on future mortality rates that materialise over a longer timeframe, such as increased mortality rates arising from delays in receiving treatments for non-COVID conditions, or reduced mortality rates arising from the fact that deaths from COVID-19 may have been concentrated in individuals of poorer health, leaving a surviving pool of lives that are, on average, healthier.

12.9 It is also worth noting that:

- For annuity providers, an increase in expected future mortality rates corresponds to a reduction in the insurer's liabilities, as increased mortality rates results in annuity payments being paid over shorter periods than expected; and
- Both PAC and Rothesay reinsure significant proportions of their longevity risk, and therefore changes in assumptions relating to future mortality rates have a lower effect on the Companies' annuity liabilities than would be the case in the absence of this reinsurance.

12.10 The long-term impacts of COVID-19 are highly uncertain, and I will comment on this area again in my 2021 Supplementary Report, but in light of the above, I am currently satisfied that any changes made to mortality assumptions in response to the direct or indirect impacts of COVID-19 will either be relatively minor, or will affect PAC and Rothesay in a broadly similar way.

THE APPROACH TO COMMUNICATION WITH POLICYHOLDERS

12.11 Regulations made under FSMA require a communication regarding the proposed transfer to be sent to every policyholder of the parties under the Scheme. However, this requirement may be waived at the discretion of the Court, which will give consideration to issues such as the practicality and costs of sending notices against the likely benefits for policyholders of receiving such communications. The Companies received such waivers at the 2019 Directions Hearing. In order to comply with SUP 18.2.46G of the FCA Handbook, the Companies are required 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.

12.12 Regulations require that a legal notice in a form approved by the PRA is published in the London, Edinburgh and Belfast Gazettes, as well as two national newspapers in the United Kingdom.

12.13 The Companies complied with the statutory communication requirements ordered to be carried out by the Court, after granting certain waivers, at the 2019 Directions Hearing, resulting in the following communications being sent:

- PAC sent an information pack on the Scheme (the "**2019 PAC Policyholder Pack**") to all Transferring Policyholders with the exception of certain groups. For these groups PAC was granted a waiver from notifying them of the Scheme.

- Rothesay sent a letter on the Scheme to its existing policyholders (the "**2019 Rothesay Policyholder Letter**") with the exception of certain groups. For these groups Rothesay was granted a waiver from notifying them of the Scheme.

12.14 At the 2019 Directions Hearing PAC was granted a waiver from notifying its non-transferring policyholders (including non-transferring annuitants) of the Scheme.

12.15 In addition to the 2019 PAC Policyholder Pack, PAC also sent three letters to Transferring Policyholders updating them on the Appeal. Rothesay has not sent any other communications to its policyholders since the 2019 Rothesay Policyholder Letter, but has kept its website updated with developments in relation to the Scheme.

12.16 The Companies have received advice that, having complied with the communication requirements from the 2019 Court Process, they are under no legal obligation to issue further policyholder communications on the Scheme. However, PAC believes it is nonetheless appropriate to issue an updated information pack on the Scheme to Transferring Policyholders (the "**2021 PAC Policyholder Pack**"). PAC does not intend to send any Scheme-related communications to non-transferring policyholders. More details of PAC's communications strategy are given in paragraphs 12.22 to 12.36.

12.17 Rothesay is keeping its website up to date with developments in relation to the Scheme, but it does not intend to issue any further mailing packs or letters on the Scheme to its existing policyholders, other than to:

- the 10 policyholders who submitted an objection to the transfer in 2019, and to provide further information where specifically requested on an individual basis or to respond to a query or objection; and
- trustees of the pension schemes that have entered into buy-in transactions with Rothesay since the 2019 Rothesay Policyholder Letter was issued[109].

Rothesay will also issue a welcome letter to Transferring Policyholders if the Scheme is approved by the Court. More details of Rothesay's communications strategy are given in paragraphs 12.37 onwards.

12.18 As described in paragraph 12.16, the Companies have received advice that they have complied with the communication requirements from the 2019 Court Process, and therefore they believe that they are under no legal obligation to publish legal notices in newspapers or other publications. However, given the time that has elapsed since the 2019 Court Process, the Companies believe it is appropriate to publish new notices of the Scheme, and therefore intend to publish notices of the Scheme, referencing the date of the 2021 Sanction Hearing and the other required information, in The Times, The Financial Times, The Daily Telegraph, The Sun, The Daily Mail and The Daily Mirror. This reflects a similar approach to that taken during the 2019 Court Process.

12.19 At the 2019 Directions Hearing the Companies were granted a waiver in relation to the requirement to advertise the Scheme in every EEA state and, instead, advertised only in those EEA states where more than 100 Transferring Policyholders currently reside[110]. The Companies do not intend to undertake any further advertising of the Scheme outside the UK.

12.20 Policyholders of PAC and Rothesay, and other interested parties, will be able to obtain information from the PAC and Rothesay websites as well as PAC's financial adviser website. These will contain documents regarding the Scheme, including the full Scheme document, this Report (and, in due course, my 2021 Supplementary Report), a summary of the terms of the Scheme and a summary of this report (written by me). In addition, the PAC website and PAC's financial adviser website will include copies of the reports of PAC's Chief Actuary and With-Profits Actuary, and all the information included in the 2021 PAC Policyholder Pack. The Rothesay website will also include a copy of the report on the Scheme by Rothesay's Chief Actuary.

[109] Trustees of pension schemes which entered into buy-in transactions with Rothesay after the 2019 Rothesay Policyholder Letter that were subsequently converted into buyouts will not be written to by Rothesay as they are no longer policyholders.

[110] Republic of Ireland, France, Germany, Greece, Italy, Spain and Portugal

12.21 Rothesay and PAC have also publicised details of the 2021 Directions Hearing on their websites, advising policyholders that they have a right to attend this Hearing but that it is a matter for the Court as to whether policyholders will be permitted to participate in the Hearing.

Notification of Transferring Policyholders

12.22 PAC has proposed a communication plan, including the 2021 PAC Policyholder Pack, to provide notification of the proposed transfer to all Transferring Policyholders (including relevant trustees or employers holding policies on behalf of pension scheme beneficiaries).

12.23 It is proposed that each PAC policyholder included within the scope of the communication plan will receive the 2021 PAC Policyholder Pack, the contents of which are consistent with those of the 2019 PAC Policyholder Pack. In particular, the 2021 PAC Policyholder Pack will comprise a covering letter and an information booklet containing:

- A summary of the terms of the Scheme;
- A summary of this Report;
- A questions and answers section; and
- A copy of the legal notice of the transfer.

12.24 I have reviewed draft versions of the documents to be included in the 2021 PAC Policyholder Pack and have provided comments to PAC. I consider that the most recent drafts I have reviewed provide a satisfactory level of information on the proposed transfer and a clear explanation of the consequences for transferring policyholders.

12.25 At the 2019 Directions Hearing, PAC was granted waivers from notifying the following groups of Transferring Policyholders:

- **"Goneaways":** Policies where PAC does not have a valid address for the policyholder or pension scheme and subsequent reasonable attempts to trace the policyholder or scheme have been unsuccessful are classed as "Goneaways". PAC will not be able to notify these policyholders or pension schemes;
- **Attorneys:** Where PAC's database records that a policyholder has appointed an attorney in respect of the policy, the attorney will be notified instead of the policyholder;
- **Beneficiaries under group schemes:** In general, PAC will notify the trustees rather than beneficiaries. However, for buy-ins where PAC has an existing arrangement in place with a trustee to directly contact that trustee's beneficiaries, PAC will notify the beneficiaries instead;
- **Contingent annuitants:** For policies that may pay an individual an annuity in the future (but there is not yet an annuity in payment), the contingent annuitant will not be notified. This is because PAC does not, generally speaking, communicate with contingent beneficiaries and does not hold contact details for them prior to any benefits becoming due to them. However, the 2021 PAC Policyholder Pack asks recipients to draw the contents of the pack to the attention of others, including contingent beneficiaries;
- **Trustees-in-bankruptcy, receivers and administrative receivers:** For policies where the policyholder has been declared bankrupt, the policyholder will be notified rather than the trustees-in-bankruptcy, receivers or administrative receivers, unless PAC has a record in its databases of the appointment of the trustee-in-bankruptcy, receiver or administrative receiver;
- **Pension Sharing Orders:** Some policies are subject to a Pension Sharing Order where a court has ordered that some or all of the benefits are paid to the policyholder's former spouse with any remainder being paid to the policyholder. PAC will notify policyholders with the benefit of a Pension Sharing Order where PAC's records show the existence of that Pension Sharing Order;

- **Deceased policyholders:** For policies for which PAC has been notified of the death of the policyholder but the benefits have not yet been settled, PAC will not attempt to notify the executors or personal representatives the policyholder. The policyholder's spouse will only be notified if they have a contingent benefit under the policy; and
- **Accidental omissions:** Some of the Transferring Policyholders may not be sent a policyholder pack as a result of an accidental omission or an intervening event that is outside of PAC's direct control. PAC will remedy any such failure in advance of the final Court hearing wherever possible.

12.26 PAC estimates that there are currently 1,202 of the Transferring Policies which are goneaways or where the electronic policy records have invalid or missing addresses as at 31 December 2020. PAC performs regular exercises to ensure the accuracy of its policyholder data, using a third party tracing agency. Additionally, given the number of communications on the Scheme issued to the population of Transferring Policyholders, and PAC's active approach to following up goneaway notifications, the proportion of goneaways within the Transferring Policyholders has reduced significantly since 2019.

12.27 I am satisfied that PAC has made sufficient efforts to ensure that the groups listed in paragraph 12.25 are as small as possible, and I am therefore satisfied that it was reasonable for PAC to seek a waiver from notifying these groups.

12.28 In relation to advertising in EEA states, I understand that the relevant requirements were complied with in 2019, subject to the waivers granted by the Court at the 2019 Directions Hearing set out in paragraph 12.19 above. I also understand that such advertising would not be a requirement for a new Part VII scheme following the UK's exit from the EU. I am therefore satisfied that the Companies' proposed approach of not undertaking further advertising of the Scheme in EEA states is reasonable.

Non-notification of non-transferring policyholders of PAC

12.29 During the 2019 Court Process PAC was granted a waiver from the requirement to directly contact its non-transferring policyholders, including Non-Transferring Reinsured Policies and other non-transferring PAC annuity policyholders. PAC intends to follow the same approach in respect of the 2021 Court Process.

12.30 PAC considers that it would be disproportionate to notify these policyholders given that PAC considers that the Scheme will not affect the security, reasonable benefit expectations or service standards of the non-transferring PAC policyholders nor the terms and conditions of their policies.

12.31 PAC has given consideration to notifying the approximately 800,000 non-transferring PAC annuity policyholders[111] of the proposed transfer in order to clarify the status of non-transferring policyholders who may have seen media coverage of the transaction with Rothesay and who may be unsure if their policy is in the scope of the transaction. However, PAC believes that the number of policyholders who are aware of the transfer and unsure as to whether their policy is part of the Transferring Business is likely to be small, and that the benefit of clarifying their status needs to be balanced against the risk of confusion and unsettlement caused by notifying those that had not previously been aware of the Rothesay transaction, which PAC believes to be a much larger proportion of the non-transferring PAC policyholders. It should also be noted that PAC has not received a large volume of enquiries from non-transferring annuitants wishing to clarify their status in relation to the transfer in the three years since the transfer was first publicised.

12.32 I am satisfied that the non-transferring PAC policyholders, including non-transferring PAC annuity policyholders, do not need to receive formal notification of the Scheme.

12.33 However, during the 2019 Court Process I challenged PAC on whether the non-transferring PAC annuity policyholders should nevertheless receive a brief letter confirming that they are not included in the proposed transfer. While those policyholders will not be materially affected by the proposed transfer, they would not have been able to determine from any general description of the Transferring Business whether their policy is within the scope of the transfer. In

[111] Holders of annuity PAC policies that are not in-scope of the Scheme. This includes Non-transferring Reinsured Policies as well as holders of PAC annuities which were not in scope of the Reinsurance Agreement.

response, PAC set up a web-based tool that PAC policyholders could use to confirm whether they are in scope of the proposed transfer, and additionally a phone line for policyholders to call for more information.

12.34 The web-based tool remains active, although I consider it unlikely that a significant number of non-transferring PAC annuitants would now be uncertain about their policy's status in relation to the transfer.

12.35 Taking this into account, I am satisfied that PAC's approach of not notifying non-transferring PAC policyholders is reasonable.

12.36 It should be noted that, where Transferring Policyholders also hold non-transferring policies of PAC, the 2021 PAC Policyholder Pack on the Scheme will make it clear which of the policyholder's policies will be transferring and which will remain policies of PAC.

Non-notification of certain policyholders of Rothesay

12.37 Rothesay sent the 2019 Rothesay Policyholder Letter to its policyholders during the course of the 2019 Court Process notifying them of the Scheme. Rothesay has received advice that, as it has complied with the statutory communication requirements (as directed by the Court in the 2019 Directions Hearing), it is not required to issue any further communications to its existing policyholders on the Scheme. Furthermore Rothesay believes it would be disproportionate to do so and could potentially lead to confusion and even anxiety in some cases. Rothesay's rationale for electing not to send communications on the Scheme to its existing customers is based on the following arguments:

- The scheme has no impact on existing Rothesay policyholders, as Rothesay has already accepted the economic risk and rewards of the Transferring Business via the Reinsurance Agreement;
- During the 2019 Court Process Rothesay did notify its existing policyholders of the proposed transfer, and received a minimal response from this exercise.
- Rothesay has received minimal contact from policyholders in relation to the Scheme since the end of the 2019 Court Process.
- The cost of notifying existing policyholders would be over £1 million and Rothesay considers that this is disproportionate given the reasons listed above.

12.38 Notwithstanding that Rothesay believes it would be disproportionate to undertake a mass mailing of its policyholders in relation to the Scheme, Rothesay does intend to send a letter (the "**2021 Rothesay Trustee Letter**") to trustees of the pension schemes that have entered into buy-in transactions with Rothesay since the 2019 Rothesay Policyholder Letter was issued in February 2019[112]. For the avoidance of doubt, the 2021 Rothesay Trustee Letter will not be sent to individuals who have been issued a Rothesay policy as a result of a buyout of their pension scheme benefits by Rothesay since February 2019.

12.39 Given that:

- The financial risks associated with the Transferring Business have already been transferred to Rothesay and therefore the financial impact of the Scheme on Rothesay is not material;
- Rothesay is free to enter into large buy-in or buyout transactions that have a much more significant financial impact on Rothesay than the Scheme without consulting or notifying its existing policyholders;
- Rothesay has had minimal engagement from policyholders in relation to the Scheme;
- Rothesay is keeping its website (https://www.rothesay.com/prudential-transaction/) up-to-date with information on the Scheme; and

[112] Trustees of pension schemes which entered into buy-in transactions with Rothesay after the 2019 Rothesay Policyholder Letter that were subsequently converted into buyouts will not be sent the 2021 Rothesay Trustee Letter as they are no longer policyholders.

- In my view, the 2019 Rothesay Policyholder Letter did not set a reasonable expectation that Rothesay would continue to provide similar communications regarding the Scheme to its policyholders,

I am satisfied that Rothesay's approach of not notifying existing policyholders (other than those mentioned in paragraph 12.17) is reasonable when set against the costs of undertaking the notification. I am also satisfied that is proportionate for Rothesay to send the 2021 Rothesay Trustee Letter, as described in paragraph 12.38, given the low costs involved in doing so.

Notification of the 2021 Directions Hearing

12.40 I am satisfied that the Companies' approach to publicising the 2021 Directions Hearing, as set out in paragraph 12.21, is appropriate, as there may be policyholders who have an expectation or desire to attend both the 2021 Directions Hearing and the 2021 Sanction Hearing. I am also satisfied that it is appropriate for the Companies to make policyholders wishing to attend the 2021 Directions Hearing aware that they may not have an opportunity to be heard during the Hearing, as this is not within the Companies' control and is a matter for the Court.

Vulnerable customers

12.41 PAC and Rothesay have both shared with me their approaches to dealing with vulnerable consumers and they have both confirmed that their approaches will be maintained during all communications with policyholders in relation to the proposed transfer.

Overall conclusion on the approach to communication with policyholders

12.42 I am satisfied that the Companies' proposed approaches to communication with their respective policyholders is fair and reasonable.

THE COSTS OF THE SCHEME

12.43 PAC and Rothesay will each bear the cost of notifying their own policyholders of the Scheme. My Independent Expert fees, Court fees and counsel's fees will be shared equally between the parties, as will the costs of any advertisements in respect of the Scheme. All other costs will be borne by the party that incurs them.

12.44 Costs associated with the Scheme that are attributable to PAC will be met from PAC's shareholder funds and not by policyholders or resources of the PAC With-Profits Fund. Costs attributable to Rothesay will be met from Rothesay's shareholder funds and not by policyholders.

12.45 I am satisfied that this approach to meeting the costs associated with the Scheme is reasonable.

EXTERNAL REINSURANCE WHERE PAC OR ROTHESAY IS THE CEDANT

12.46 Under the terms of the Scheme, there will be no change to the reinsurance contracts for which Rothesay is the cedant, or to reinsurance contracts for which PAC is the cedant and which relate to non-transferring PAC policies.

12.47 As noted in Section 7, longevity reinsurance arrangements in respect of the Transferring Business will transfer from PAC to Rothesay under the Scheme. Rothesay has informed me that, where it already has a relationship with one or more of those reinsurers, it may seek to align the terms of the relevant transferring treaties with the terms of its existing reinsurance arrangements with such reinsurer(s). I note that any such alignment would be a commercial negotiation that would be subject to the consent of the reinsurer in question.

12.48 Reinsurers are exposed to risk of default by the cedant with respect to any reinsurance premiums due in excess of any collateral posted under the reinsurance treaty. If the Scheme is implemented, Rothesay will become the cedant for the longevity reinsurance treaties that relate to the Transferring Business, and all contractual terms of the treaties will remain the same other than by mutual agreement between Rothesay and the relevant reinsurer. I have considered the capital management policy, governance and financial strength of Rothesay in comparison to PAC in Section 8. I consider that there will be no material change to the financial strength of the cedant and therefore I conclude that the Scheme would not lead to a material change in the security of reinsurance premiums under the longevity reinsurance treaties that relate to the Transferring Business.

12.49 I am therefore satisfied that the Scheme will not have a material effect on the reinsurers of the PAC or Rothesay policies.

IMPACT OF THE SCHEME ON SUBSIDIARIES OF PAC

12.50 PAC has two active insurance subsidiaries, PPL and PIA, which are assets of the PAC SHF. In relation to PPL and PIA:

- The implementation of the Scheme will have no impact on the financial position of PPL or PIA, and in particular no assets or liabilities will move in or out of PPL or PIA as a result of the Scheme;
- The implementation of the Scheme will result in a small increase in PAC's SCR Coverage Ratio, and therefore it will not adversely affect PAC's ability to provide capital support to PPL or PIA should PAC consider it appropriate to do so; and
- As stated in paragraph 9.50, my conclusions in relation to the non-transferring policyholders of PAC apply equally to PIA in its capacity as a cedant to PAC under the reinsurance arrangements described in paragraph 5.33.

12.51 I am therefore satisfied that the implementation of the Scheme will not have a material adverse effect on policies of PPL or PIA.

12.52 Rothesay has no subsidiaries containing insurance business.

EVENTS SINCE THE FINANCIAL INFORMATION IN THIS REPORT WAS PRODUCED

12.53 The financial information in this Report is based on the Solvency II financial positions of the Companies at 31 December 2020. As at the time of finalising this Report, financial market conditions have changed since 31 December 2020, with the most relevant changes being:

- GBP interest rates (based on swap rates) at medium to long durations have increased by between 0.5 and 0.6 percentage points;
- Credit spreads on long duration investment grade corporate bonds are at roughly the same level as at 31 December 2020;
- The FTSE 100 share index has increased by approximately 9%.

12.54 I have been provided with estimated SCR Coverage Ratios of the Companies as at 28 May 2021, which show that the differential between the estimated SCR Coverage Ratios of PAC and Rothesay has not changed significantly since 31 December 2020. Consequently my conclusions that reference the relative SCR Coverage Ratios of PAC and Rothesay are unaffected by these changes.

12.55 I will comment on the actual Solvency II financial positions of the Companies as at 30 June 2021 in my 2021 Supplementary Report.

UNITED KINGDOM’S EXIT FROM THE EUROPEAN UNION (“BREXIT”)

12.56 The United Kingdom left the European Union on 31 January 2020, subject to a transition period under which EU rules on trade, travel and business continued to apply until 31 December 2020.

12.57 PAC and Rothesay have both confirmed to me that Brexit has not affected their ability to continue to service and manage their policies, including Transferring Policies that are held by policyholders currently residing overseas.

12.58 As described in paragraph 4.8, following Brexit the UK is now free to diverge from the EU’s insurance regulatory framework, and consultations are underway to determine what a UK regulatory framework for insurance companies might look like. It is possible that any future regulatory framework could result in material changes to the way in which the financial strength of insurers such as PAC and Rothesay is determined, but it would be speculative to attempt to predict the nature of these changes other than to say that, in my view, they are unlikely to materially affect policyholder benefit security for the reasons set out in paragraphs 8.110 and 8.111. To the extent that future changes to the UK regulatory regime become known in advance of the 2021 Sanction Hearing, I will comment further on such changes in my 2021 Supplementary Report.

12.59 In light of the above, I am satisfied that Brexit and potential consequences of Brexit do not change my conclusions in relation to the Scheme.

THE LIBOR-SONIA TRANSITION

12.60 As described in paragraph 4.9, from 31 July 2021 the PRA is changing the way it determines the risk-free interest rate curve that is required to be used by UK insurers to determine their regulatory solvency position for GBP-denominated liabilities.

12.61 Both Companies have informed me that they do not expect the impact of this change on their pre- or post-Scheme regulatory solvency position to be material, but I will comment further on the impact of this change in my 2021 Supplementary Report.

ASSET COUNTERPARTIES

12.62 Although there may be some adjustments to the premium paid between by PAC to Rothesay prior to the Transfer Date, the Scheme will not result in a transfer of financial assets. Therefore there will be no legal issues regarding asset counterparties.

TAX

12.63 Confirmation and clearance that the transaction is not for an “unallowable purpose” for corporation tax purposes was granted by HM Revenue and Customs (“**HMRC**”) to PAC on 11 March 2019 and Rothesay on 29 March 2019, and that clearance that the “transfer of going concern” treatment will apply for VAT purposes was not provided by HMRC on the grounds that such clearance is only provided in cases where there is clear uncertainty surrounding the treatment of the transaction. Given that the Scheme is materially unchanged from that put forward during the 2019 Court Process, the Companies do not intend to seek reconfirmation from HMRC that the transaction is not for an unallowable purpose.

12.64 As described in paragraphs 7.37 to 7.39, it is intended that administration services for Transferring Policies will continue to be provided by PAC for a period of approximately 6 to 12 months after the Transfer Date. However, after the Transfer Date it will be necessary to use Rothesay’s Pay As You Earn (“**PAYE**”) reference for Transferring Policies. For some holders of Transferring Policies, this may trigger a change in their PAYE tax code, either at or directly after the Transfer Date. Rothesay and PAC liaised with HMRC during the 2019 Court Process to establish the best approach to minimise any inconvenience for affected policyholders, and the Companies intend to re-engage with HMRC at an early stage to ensure that, as far as practicable, transferring policyholders' tax codes are not affected by the proposed transfer.

OTHER CREDITORS

12.65 PAC and Rothesay have informed me that there are no bondholders or third parties to securitisation arrangements or any other creditors of either company whose interests would be affected by the implementation of the Scheme.

FUTURE CORPORATE TRANSACTIONS

12.66 I am not aware of any future transfers or corporate transactions, although I note that Rothesay's longstanding strategy involves the regular execution of transactions of varying sizes with defined benefit pension schemes and insurance companies, and therefore it is to be expected that such transactions will continue to take place.

12.67 Any future transfers of insurance business into or out of either company would be subject to the usual Part VII transfer process and its associated safeguards. Any future corporate transactions involving the acquisition or disposal of another insurance company would be subject to a 'Change in Control' process which requires the approval of the PRA and the FCA. In both cases the process would consider the impact of any transaction on affected policyholders.

FINANCIAL SERVICES COMPENSATION SCHEME ("FSCS") AND FINANCIAL OMBUDSMAN SERVICE ("FOS")

12.68 FSCS is a company limited by guarantee, with statutory backing, which provides compensation to customers of authorised financial institutions (such as banks and insurers) in the event that the institution is in default (meaning unable to pay).

12.69 The eligibility of holders of long-term insurance policies for compensation from the FSCS, and the amount of compensation payable, are dependent upon the type of policyholder, the type of policy and where the insurer is based. The FSCS will pay compensation to eligible individual holders of long-term insurance policies issued by UK insurers in the UK and, in some circumstances, EEA states, in the event of the insurer's default. Compensation to eligible holders of annuities in payment is the full amount of the annuity, without limit. I note that the FSCS is an unfunded scheme which relies on levies on participating financial institutions to cover compensation costs.

12.70 Following the implementation of the Scheme, the Transferring Policyholders will have the same entitlement to compensation from the FSCS as they would have if the Scheme were not to be implemented and PAC were to default or become insolvent. Therefore, the implementation of the Scheme will not adversely affect eligibility for compensation from the FSCS for any transferring or non-transferring PAC policyholders or for the existing Rothesay policyholders. I have set out in Section 8 (without reliance on the existence of the FSCS) why I do not believe the implementation of the Scheme will materially adversely affect the security of benefits under the Transferring Policies, and therefore the likelihood that Transferring Policyholders will need to have recourse to the FSCS is, in my view, materially unchanged by the Scheme.

12.71 The FOS is an independent public body that aims to resolve disputes between individuals and UK financial services companies, and may make compensation awards in favour of policyholders. Only holders of policies that constitute business carried on in the UK are permitted to bring complaints to the FOS. In circumstances where PAC currently refers policyholders to the FOS (including, for the avoidance of doubt, Jersey and Guernsey policyholders), Rothesay will continue to do so following implementation of the Scheme. Any outstanding FOS complaints at the Transfer Date in respect of Transferring Policies will be handled and settled by PAC.

12.72 Implementation of the Scheme will not adversely affect access to the FOS for either transferring or non-transferring policyholders.

THE EFFECT OF THE PROPOSED SCHEME ON THE NATURE AND VALUE OF ANY RIGHTS OF POLICYHOLDERS TO PARTICIPATE IN PROFITS

12.73 All of the Transferring Policies are non-profit in nature and therefore have no right to participate in profits; this will not change as a result of the Scheme.

12.74 All of Rothesay's existing policies are non-profit in nature and therefore have no right to participate in profits; this will not change as a result of the Scheme.

12.75 The PAC With-Profits Fund contains with-profits policies with the right to participate in profits. The Scheme will not affect the right of these policies to participate in profits, and I have concluded in paragraph 9.41 that the Scheme will not have a material adverse effect on the reasonable benefit expectations of holders of policies invested in the PAC With-Profits Fund.

12.76 I am therefore satisfied that the implementation of the Scheme will not materially adversely affect the nature and value of any rights of policyholders to participate in profits.

THE EFFECT OF THE PROPOSED SCHEME ON PREVIOUS SCHEMES

12.77 Allen & Overy LLP, acting for PAC, and Latham & Watkins LLP, acting for Rothesay, have carried out legal reviews of relevant previous PAC and Rothesay schemes respectively and have confirmed that there were no enduring provisions in those schemes that would be affected by this Scheme and that I would need to consider in the context of the proposed transfer.

12.78 As discussed in Section 4, I am satisfied that it is appropriate for me to rely on the conclusions of Allen & Overy LLP and Latham & Watkins LLP in relation to the Scheme.

THE FUTURE OPERATION OF THE SCHEME

12.79 If the Scheme is approved by the Court (and subject to any subsequent amendment of the Scheme, as considered below), the Directors of PAC and Rothesay are committed to implementing the Scheme as set out in the Scheme document (and reflected in this report) in accordance with their fiduciary responsibilities under UK company law.

12.80 At any time after the Court's sanction of the Scheme, PAC and Rothesay must apply to the Court for sanction of any amendments to it, except where the amendment is:

- Considered to be minor or technical;
- Required by law;
- Required to reflect changes in actuarial techniques and practices; or
- Required to protect the rights and reasonable expectations of policyholders.

In these cases the Companies must notify the PRA and FCA.

12.81 The published financial position of PAC and Rothesay will be derived by the Companies' actuaries and accountants who are subject to professional standards, and will be subject to external audit. The business being transferred consists of non-profit business and therefore the most important aspect is that Rothesay will continue to meet any guaranteed liabilities and that sufficient resources are put aside to enable this.

12.82 In my opinion there are reasonable safeguards in place to ensure that, if approved by the Court, the Scheme will be operated as presented.

THE JERSEY AND GUERSNEY SCHEMES

12.83 For the avoidance of doubt, my conclusions in relation to the Scheme would not be altered if the Jersey and/or the Guernsey Scheme were not to proceed for any reason.

GMP EQUALISATION

12.84 Guaranteed minimum pensions ("**GMP**") were a consequence of the introduction in 1978 of the ability to contract-out of the State Earnings Related Pension Scheme into an occupational pension scheme. Upon contracting-out, pension schemes were required to provide a defined benefit, i.e. the GMP, which was required to be determined on an unequal basis between males and females, with the age at which it can be drawn and rate at which benefits build up being different for men and women.

12.85 On 17 May 1990 the Court of Justice of the European Union ruled that occupational pension schemes constituted deferred pay and therefore must treat men and women equally, which was interpreted by the UK Government as requiring GMPs to be equalised between men and women.

12.86 On 30 October 2018, the Court ruled in *Lloyds Banking Group Pensions Trustees Ltd v Lloyds Bank PLC and others* that, in this case, the pension scheme trustees were *"under a duty to amend the schemes in order to equalise benefits for men and women so as to alter the result which is at present produced in relation to GMPs".*

12.87 PAC is in the process of reviewing certain defined benefit pension schemes where the pension ages have not been equalised, which may necessitate augmentations being made to pension amounts. To the extent that such future augmentations are required in relation to Transferring Policies, it is currently anticipated that PAC and Rothesay would mutually agree terms on which Rothesay will assume liability for the augmented payments.

12.88 To the extent that further benefit augmentations are required in relation to gender equalisation, PAC and Rothesay will take the same approach of mutually agreeing terms for the transfer of the liability to Rothesay.

12.89 I am satisfied that this approach is reasonable, and that the plausible outcomes in relation to GMP equalisation will not change my conclusions in relation to the proposed transfer.

13. Correspondence and Questions from Policyholders

13.1 PAC has received a large number of comments and questions on, and objections to, the Scheme from policyholders and representatives of policyholder schemes (e.g. trustees or employers)[113] via email, letter and telephone. The vast majority of this correspondence was received in advance of the 2019 Sanction Hearing, but further correspondence has also been received by PAC since that point. Comments have also been received by PAC's solicitors and forwarded to PAC.

13.2 Rothesay has also received a small volume of correspondence from its own policyholders and from PAC's policyholders on the Scheme.

13.3 It would not be typical for an independent expert to comment on correspondence from affected policyholders in the scheme report submitted to the Directions Hearing as, at the point at which that report is submitted, details of the scheme would not normally be known to policyholders. The independent expert would, instead, comment on correspondence from affected policyholders in a supplementary report. However, in this case, I understand that the Companies intend to resubmit all objections received in relation to the Scheme, including those submitted to the Court during the 2019 Court Process, and to the Court for the 2021 Court Process. This is because the Companies wish to take a prudent approach to policyholder objections by assuming that all objections lodged during the 2019 Court Process remain valid, despite the outcome of the Appeal. Consequently it is, in my view, appropriate to comment in this Report on the correspondence received by the Companies to date.

13.4 I will comment on any correspondence received by the Companies after the date on which this Report is finalised in my 2021 Supplementary Report.

13.5 I have been provided with summaries of all submissions that have been classed by PAC and Rothesay as objections to the Scheme on or prior to 25 May 2021. I understand that copies of all objections and associated responses will be provided to the Court, the PRA and the FCA.

13.6 During the 2019 Court Process I received email correspondence from a PAC policyholder outlining some concerns in respect of the Scheme, to which I responded directly. I was also copied into a letter to PAC from a PAC policyholder objecting to the Scheme; as this letter was addressed to PAC, I did not respond directly to the policyholder, but I have addressed the substance of the policyholder's objection in this section.

13.7 Between February and June 2021 I have received several emails, and some telephone calls, from a PAC policyholder who took part in the 2019 Sanction Hearing and in the Appeal hearing in 2020; the emails included copies of the policyholder's correspondence with PAC, the PRA and the FCA. The policyholder raised a number of concerns which he wished me to take into account in preparing this Report. I have endeavoured to address all the issues raised where they are relevant to my review of the Scheme and its effect on the interests of Transferring Policyholders.

OBJECTIONS

13.8 As at 24 May 2021, PAC had received 1,184 objections to the Scheme, of which 1,076 were submitted to the Court during the 2019 Court Process. In addition to the 1,076 objections submitted to the Court, PAC received an additional 5 objections prior to the 2019 Sanction Hearing that were not submitted to the Court owing to an administrative oversight[114]. 38 of the objectors who submitted objections prior to the 2019 Sanction Hearing have submitted further or repeated objections to PAC since then. All of the objections received were from Transferring Policyholders.

13.9 To put the number of objections into context, the 1,184 objections received by PAC represent approximately 0.3% of the number of Transferring Policies as at 31 December 2020.

[113] For clarity I will refer to both policyholders and representatives of policyholder schemes as 'policyholders' in this section.

[114] For the avoidance of doubt, I have now had an opportunity to consider these 5 objections and am satisfied that none of them raises issues that are not addressed by this Report.

13.10 I have reviewed summaries of all of the objections PAC received and I have also reviewed a sample (chosen by me) of the correspondence between PAC and the objecting policyholders. Based on this sample, I consider that the responses by PAC appropriately address the questions or issues raised. I am also satisfied that the criteria used to determine whether a submission should be classified as an objection are reasonable.

13.11 Rothesay received 11 objections to the Scheme from its policyholders during the 2019 Court Process[115], and has not received any further objections from its policyholders to the Scheme. I reviewed the correspondence between Rothesay and its existing policyholders, and I considered that the responses by Rothesay appropriately addressed the questions or issues raised. I am also satisfied that the criteria used to determine whether a submission should be classified as an objection are reasonable.

13.12 The objections can be classed under the following broad headings:

- Policyholders who are concerned that their policy is moving to a company from which they would not have chosen to buy a policy. (see paragraphs 13.14 to 13.15).
- Policyholders who are concerned with the security of benefits for the Transferring Business that will be provided by Rothesay, when compared to PAC (see paragraphs 13.16 and 13.17).
- Policyholders who object because they are concerned that their benefit payments might change as a result of the proposed transfer (see paragraph 13.18).
- Policyholders who are concerned about their eligibility for compensation should Rothesay default or become insolvent (see paragraph 13.20).
- Policyholders who are concerned that the costs associated with the proposed transfer are being paid for by policyholders (see paragraphs 13.21 and 13.22).
- Policyholders who do not want their policy to be moved without their authority and wish to have the right to opt out or vote (see paragraphs 13.23 and 13.24).
- Policyholders who object because they were not made aware that their policy could transfer to another organisation when it was purchased, or because they believe PAC is breaching its contracts with them by transferring them to another organisation (see paragraphs 13.25 to 13.27).
- Policyholders who believe it is unfair that PAC is able to transfer their policies to another company but policyholders are not themselves able to do so (see paragraphs 13.28 and 13.29).
- Policyholders who are concerned that Rothesay does not have the necessary expertise to manage their policies (see paragraph 13.30).
- Policyholders who, as a result of the proposed transfer, will have one or more annuity policies with PAC and one or more annuity policies with Rothesay and therefore, are concerned that dealing with multiple companies will be inconvenient for them and their families (see paragraphs 13.31 to 13.33).
- Policyholders who want their policy to remain with PAC because they chose specifically to take out a policy with PAC based on its reputation (see paragraphs 13.34 to 13.36).
- Policyholders who do not want to be transferred due to previous experiences of Rothesay's administration of existing policies (see paragraphs 13.37 to 13.41).
- Policyholders who do not believe there has been sufficient justification regarding the selection of Transferring Policies (see paragraphs 13.42 to 13.44).
- Policyholders who do not wish their personal details to be shared with Rothesay (see paragraphs 13.45 to 13.46).

[115] One of these 11 policyholders is now no longer a Rothesay policyholder.

- Policyholders who are concerned that the proposed transfer will weaken Rothesay's financial strength in the long-term (see paragraphs 13.47 to 13.48).
- Policyholders who are concerned by the benefit to Rothesay's financial position as a result of the use of the Matching Adjustment (see paragraphs 13.49 to 13.50).
- Policyholders who are concerned by the benefit to Rothesay's financial position as a result of the use of the TMTP (see paragraphs 13.51 to 13.52).
- Policyholders who are concerned by Rothesay's use of debt to support its capital base (see paragraphs 13.53 to 13.54).
- Policyholders who are concerned by Rothesay's investments in assets linked to ground rent on leasehold properties (see paragraph 13.55).
- Policyholders who are concerned by Rothesay's investments in lifetime mortgage assets (see paragraph 13.56).
- Policyholders of PAC who are concerned by aspects of PAC's practices and standards in relation to customer service, customer communications and internal record-keeping (see paragraphs 13.57 to 13.62).
- Policyholders who are concerned by the divestment from Rothesay of Goldman Sachs and Blackstone in 2017 and 2020 respectively (see paragraphs 13.63 to 13.65).
- Policyholders who are concerned that they will not be provided the opportunity to attend and participate in the 2021 Directions Hearing (see paragraphs 13.66 and 13.67).
- Policyholders who have expressed doubts over the recognition of a Court order by EEA countries following the UK's exit from the EU (see paragraphs 13.68 to 13.70).

13.13 The main arguments and issues put forward in the objections are listed below, together with my response.

Policyholders who are concerned that their policy is moving to a company from which they would not have chosen to buy a policy

13.14 Many of the objectors have expressed concern that Rothesay is a less-well known company than PAC and that it was founded only fourteen years ago.

13.15 However, the security of policyholders' benefits depends primarily on factors other than the level of prominence and age of the company. Rothesay is an authorised insurance company, regulated by the PRA and FCA, and has capital resources in excess of its minimum regulatory capital requirements and will continue to do so after the transfer. As noted in Section 8, I am satisfied that the proposed transfer will not have a material adverse effect on the security of benefits for Transferring Policies, or on the service standards and governance applicable to their policies. Additionally, the Appeal Judgment noted that age and reputation are not relevant to the consideration of financial security.

Policyholders who are concerned with the security of benefits for the Transferring Business that will be provided by Rothesay, when compared to PAC

13.16 It is of paramount importance that the impact of any transfer of this nature on the security of benefits of all groups of policies should be considered, and this is a central focus of this Report.

13.17 Section 8 of this Report contains the analysis I have carried out to assess the impact of the Scheme on the security of benefits under the Transferring Policies, and I have concluded in paragraph 8.103 that, based on the position at 31 December 2020, the implementation of the Scheme will not have a material adverse effect on the financial resources available to support the security of the benefits of the Transferring Business.

Policyholders who object because they are concerned that their benefit payments might change as a result of the proposed transfer

13.18 As stated in paragraph 8.147, there will be no changes to the annuities payable under the Transferring Policies as a result of the Scheme. For the avoidance of doubt, this includes any policies whose benefit payments increase in line with an inflation index or otherwise.

13.19 I have set out in paragraphs 8.147 to 8.161 why I do not believe the impact of the Scheme on commutation terms available to Transferring Policyholders will result in a material adverse impact on the reasonable benefit expectations of Transferring Policyholders.

Policyholders who are concerned about their eligibility for compensation should Rothesay default or become insolvent

13.20 As stated in paragraph 12.70, the implementation of the Scheme will not adversely affect eligibility for compensation from the FSCS for any transferring or non-transferring PAC policyholders or for the existing Rothesay policyholders. Therefore should Rothesay default or become insolvent, the Transferring Policyholders will retain the same entitlement to compensation from the FSCS as they would have if the Scheme were not to be implemented and PAC were to default or become insolvent.

Policyholders who are concerned that the costs associated with the proposed transfer are being paid for by policyholders

13.21 As stated in paragraphs 12.43 and 12.44, PAC and Rothesay will each bear the cost of notifying their own policyholders of the Scheme. My Independent Expert fees, Court fees and Counsel's fees will be shared equally between the parties, as will the costs of any advertisements in respect of the Scheme. All other costs will be borne by the party that incurs them.

13.22 Costs associated with the Scheme that are attributable to PAC will be met from PAC's shareholder funds and not by policyholders or the PAC With-Profits Fund. Costs attributable to Rothesay will be met from Rothesay's shareholder funds and not by policyholders.

Policyholders who do not want their policy to be moved without their authority and wish to have the right to opt out or vote

13.23 Under FSMA, the Court will determine whether the proposals are fair to policyholders and other interested parties and so may be put into effect. The Court will take into consideration my views as the Independent Expert and the views of the financial services regulators (the PRA and the FCA), who have reviewed this transfer in detail. Taking into consideration these views, the Court will determine whether the Scheme is, as a whole, fair to policyholders of PAC (both transferring and non-transferring) and Rothesay.

13.24 The Scheme does not permit policyholders to opt out of, or vote on, the proposed transfer and this is in accordance with normal practice for such transfer schemes; it is for this reason that such transfers are subject to the process of scrutiny described in paragraph 13.23.

Policyholders who object because they were not made aware that their policy could transfer to another organisation when it was purchased, or because they believe PAC is breaching its contracts with them by transferring them to another organisation

13.25 Under FSMA, companies are able to undertake a transfer of insurance business subject to Court approval. The Court will determine whether it is appropriate in all the circumstances of the case to sanction the transfer in light of the impact on policyholders and other interested parties, taking due account of policyholder objections.

13.26 There is no general requirement for insurance companies to make their policyholders aware that their policies could be transferred to another organisation. The process being followed is that required by law to transfer insurance business between companies.

13.27 Some of PAC's Key Features Documents for annuities have included statements to the effect that annuitants will receive an income from Prudential from the rest of their life, and some policyholders have interpreted this as precluding transfer of their annuity to another insurer. At the 2019 Sanction Hearing, Mr Justice Snowden made it clear that such statements did not amount to a binding contractual commitment and did not provide valid grounds for declining to sanction a transfer.

Policyholders who believe it is unfair that PAC is able to transfer their policies to another company but policyholders are not themselves able to do so

13.28 There is no legal mechanism for individual policyholders to transfer their policies if this is not explicitly permitted by their policies' terms and conditions. In particular, the transfer of in-payment annuities is not permitted (although in certain limited circumstances holders of in-payment annuities are permitted to exchange their annuity income for a lump sum). There will be no changes to the Transferring Policies' terms and conditions as a result of the Scheme, and the Scheme does not introduce any additional options under policies that will transfer to Rothesay allowing policyholders to transfer or cash in those policies. However contingent beneficiaries of personal pension policies will gain the option to commute their benefits if these benefits fall below the trivial commutation threshold, as described in paragraph 8.151 (noting that this option is given at Rothesay's discretion and is not guaranteed).

13.29 Holders of the small number of transferring deferred annuities will continue to have the ability to commute some or all of their benefits in the same circumstances as is currently the case.

Policyholders who are concerned that Rothesay does not have the necessary expertise to manage their policies

13.30 Rothesay currently manages very large volumes of non-profit annuities and I consider that the Rothesay Board is experienced in the management and governance of non-profit annuity business and have no reason to believe that it will treat the Transferring Policyholders in a materially different way to the PAC Board.

Policyholders who, as a result of the proposed transfer, will have one or more annuity policies with PAC and one or more annuity policies with Rothesay, and are concerned that dealing with multiple companies will be inconvenient for them and their families

13.31 While it is understandable that policyholders with more than one PAC annuity policy will wish to minimise the complexity of their financial affairs, I do not consider that having annuities with two providers will result in material inconvenience to policyholders. In particular, no action is required by policyholders in relation to the transfer, and policyholders' benefit payments will continue to be paid automatically after the transfer on the days on which they are due.

13.32 Additionally, as described in paragraph 12.64, PAC and Rothesay have received assurances from HMRC that everything possible will be done to avoid incorrect PAYE tax codes being applied to Transferring Policies following the transfer. In particular, HMRC will be made aware of those Transferring Policyholders who have other annuities with PAC that are not transferring, and will take this into account in its work on PAYE tax codes.

13.33 Additionally, I have concluded that the transfer will not have a material adverse impact on the service standards applicable to the Transferring Policies.

Policyholders who want their policy to remain with PAC because they chose specifically to take out a policy with PAC based on its reputation

13.34 Many of the policyholders who objected to the proposed transfer did so on the grounds that they had specifically chosen PAC as their annuity provider based on its reputation as a reliable, long-standing and well established company.

13.35 The security of policyholders' benefits depends primarily on factors other than the level of prominence and age of the company. In particular, Rothesay is an authorised insurance company, regulated by the PRA and FCA, and has capital resources in excess of its minimum regulatory capital requirements and will continue to do so after the transfer.

13.36 As stated in paragraph 8.194, I am satisfied that the implementation of the Scheme will not have a material adverse impact on the security of benefits under the Transferring Policies, the reasonable expectations of the transferring PAC policyholders or the service standards and governance applicable to the Transferring Policies. Therefore, I have no reason to believe that the transferring policyholders will have a materially different experience as Rothesay policyholders than they would have done if they remained as PAC policyholders. While I fully understand why many

PAC policyholders draw comfort from the company's reputation, in reviewing the security of policyholders' benefits I have necessarily considered more tangible factors such as solvency cover, risk exposure and capital management policies. Additionally, the Appeal Judgment noted that age and reputation are not relevant factors in relation to transfers of this type.

Policyholders who do not want to be transferred due to previous experiences of Rothesay's administration of existing policies

13.37 Some policyholders have objected to the transfer owing to perceived poor service standards that they have experienced in relation to the administration of their existing Rothesay policies or of Rothesay policies held by a close relative.

13.38 As described in Section 7 of this Report it is intended that administration services for Transferring Policies will continue to be provided by PAC for a period of approximately 6 to 12 months after the Transfer Date. These services will be provided by PAC under the TSA which states that the service standards provide by PAC in this period must be at least the same standard as the services provided by PAC in the twelve months prior to the Transfer Date. Therefore, during the term of the TSA, I see no reason to expect that administration and service standards will differ from those that the Transferring Business would have received if the Scheme had not been implemented.

13.39 The TSA will terminate once Rothesay has completed its transfer of the administration arrangements for the Transferring Business to its service provider of choice, and Rothesay will be free to continue to make changes to administration arrangements in the same way that both PAC and Rothesay are currently free to do for their existing policyholders.

13.40 Rothesay already manages a large number of non-profit annuities and administers these via outsourcing agreements. I have reviewed the target service standards for these policies and I consider these standards to be reasonable.

13.41 It would be very unusual for there to be no isolated instances of customer dissatisfaction relating to service standards; in my experience all insurance companies experience such lapses from time to time. However, I do not believe that such instances in Rothesay's case are indicative of a wider problem which might adversely affect the service standards received by holders of Transferring Policies.

Policyholders who do not believe there has been sufficient justification regarding the selection of Transferring Policies

13.42 As described in Section 7, the Transferring Business was selected in order to achieve a target level of capital release to support the Demerger. Various practical constraints were taken into account in the original selection process, including the need to avoid separating policies covered by a single reinsurance arrangement.

13.43 In order to finalise the selection of transferring policyholders under the Scheme, a number of modifications were made to the original selection, to ensure that the composition of the Transferring Business met the commercial requirements agreed between PAC and Rothesay. In addition modifications, as described in Section 7, have been made to ensure that the Transferring Business can legally and effectively be transferred by means of the Part VII transfer.

13.44 In my view, there is no single selection approach that can be considered fairer to policyholders than any other, and so choosing the Transferring Policies on the basis of commercial, practical and legal considerations is in my view reasonable.

Policyholders who do not wish their personal details to be shared with Rothesay

13.45 I am not a legal expert, but I understand that PAC's Data Protection Notices[116] allow PAC to share policyholder details where necessary with its "Business Partners". This includes service providers and reinsurers. Therefore, under the Reinsurance Agreement, PAC would have shared some transferring policyholder data with Rothesay. PAC received

[116] A copy of PAC's Data Protection notices can be found **here** (https://www.pru.co.uk/pdf/GENM893901.pdf) for direct and advised policyholders and **here** (https://www.pru.co.uk/pdf/GENM877302.pdf) for bulk annuity policies with trustees).

legal advice at the time the Reinsurance Agreement was entered into which confirmed that PAC was able to share policyholder details related to the Reinsured Business with Rothesay.

13.46 Moreover, in transferring the Transferring Business from PAC to Rothesay, it is necessary to transfer the relevant transferring policyholders' details. The Scheme states that on the Transfer Date, Rothesay will become the data controller for all personal data comprised in the Transferring Business for which PAC is currently the data controller[117]. Therefore, if the Court sanctions this transfer, it will also sanction the transfer of policyholders' details in relation to the Transferring Policies.

Policyholders who are concerned that the proposed transfer will weaken Rothesay's financial strength in the long-term

13.47 Some policyholders of Rothesay registered objections on the grounds that the proposed transfer would pose a threat to the long-term security of their policies. My assessment of the proposed transfer has included consideration of its potential impact in the long term. I have concluded in Sections 8, 9 and 10 that the implementation of the Scheme will not have a material adverse effect on the security of the benefits of PAC and Rothesay policyholders, including the Transferring Policyholders.

13.48 In reaching this conclusion, I have taken into account that the liabilities of the Transferring Business have already been assumed by Rothesay under the Reinsurance Agreement; the proposed transfer will not change those liabilities, nor the assets available to support them. Moreover, I have allowed for the fact that Rothesay manages its risk exposures carefully and targets a solvency capital ratio that is significantly in excess of the regulatory minimum, both of which will help to counteract the effect of any potential adverse future experience. In my view there is no reason to believe that implementation of the Scheme will be detrimental to Rothesay's long term financial strength.

Policyholders who are concerned by the benefit to Rothesay's financial position as a result of the use of the Matching Adjustment

13.49 As described in Section 8:

- Use of the Matching Adjustment is permitted by UK law and the PRA has granted approval for its use to a significant number of UK life insurers;
- Both PAC and Rothesay make significant use of, and benefit significantly from, the Matching Adjustment and, as described above, the Transferring Policies were subject to the Matching Adjustment within PAC prior to the execution of the Reinsurance Agreement (and Rothesay makes use of the Matching Adjustment in relation to its liabilities to PAC under the Reinsurance Agreement);
- Rothesay holds capital under its PIM against the risks associated with the default and downgrade of all of its investments, including those held in its Matching Adjustment Portfolio; and
- The Transferring Policies are reinsured to Rothesay and therefore PAC is already to some degree dependent on Rothesay's financial position which, as described above, makes use of the Matching Adjustment,

13.50 I am therefore satisfied that Rothesay's use of the Matching Adjustment will not have a material adverse effect on the security of benefits under the Transferring Policies.

Policyholders who are concerned by the benefit to Rothesay's financial position as a result of the use of the TMTP

13.51 As described in Section 8,

- The benefit insurers achieve from the TMTP is, by design, reducing over the period from 1 January 2016 to 31 December 2031 (see paragraph 4.39), and so the benefit of this adjustment to Rothesay's solvency position will gradually reduce;

[117] For any personal data which PAC requires in relation to the TRASP PBR, PAC and Rothesay will both be separate data controllers.

- PAC's solvency position also benefits from the use of the TMTP to a similar extent to Rothesay; and
- Even if the TMTP were set to zero, Rothesay's SCR Coverage Ratio at 31 December 2020 would be 154% which is above the upper end of the range provided for in its capital management policy.

13.52 For these reasons, I am satisfied that Rothesay's use of the TMTP will not have a material adverse effect on the security of benefits under the Transferring Policies.

Policyholders who are concerned by Rothesay's use of debt to support its capital base

13.53 As described in paragraphs 6.37 and 6.56, Rothesay has issued a number of debt instruments which quality as Own Funds items under the Solvency II regulations. As further described in paragraph 6.37, interest and principal payments on all such debt instruments can be deferred (or, in one case, cancelled) if Rothesay's SCR Coverage Ratio falls below 100%. This has the effect that payment of interest and principal on the debt ranks below liabilities to policyholders.

13.54 I am therefore satisfied that Rothesay's debt issuances do not result in a material adverse effect on the security of benefits under Transferring Policies.

Policyholders who are concerned by Rothesay's investments in assets linked to ground rent on leasehold properties

13.55 I have addressed the issue of ground rent-related investments in paragraphs 8.118 to 8.125 of this Report.

Policyholders who are concerned by Rothesay's investments in lifetime mortgage assets

13.56 I have addressed the issue of lifetime mortgages in paragraphs 8.128 to 8.139 of this Report.

Policyholders of PAC who are concerned by aspects of PAC's practices and standards in relation to customer service, customer communications and internal record-keeping.

13.57 A Transferring Policyholder of PAC has provided me with details of areas of their interaction with PAC with which the policyholder is dissatisfied, including:

- Concerns that some individuals within PAC with whom the policyholder was corresponding did not have the authority to act on behalf of PAC.
- Concerns around the completeness of PAC's internal record-keeping in relation to individual policies and associated terms and conditions.
- Concerns around poor customer service standards provided by PAC and its outsourced service provider.

13.58 I have studied the concerns expressed by the policyholder in these areas, but in my view most of them are not relevant to my considerations as Independent Expert. Many of them are expressions of dissatisfaction with PAC and the policyholder's interactions with PAC, and do not appear to have a bearing on how the proposed transfer would affect policyholders, although it should be noted that the policyholder concerned does object to the proposed transfer.

13.59 One area which might have a bearing on the transfer would be if PAC did not have complete and accurate records of individual policies, resulting in Rothesay receiving incomplete or inaccurate policy details for some of the Transferring Policies. I have sought clarity from PAC on this matter, and PAC informed me that:

- It has sufficient information to administer and service all Transferring Policies (and indeed all Transferring Policyholders receive the benefits due to them from PAC), and all administration records will be provided to Rothesay;
- During 2018/2019 Rothesay undertook an audit of the policyholder records held by PAC and did not identify any concerns in relation to their completeness and accuracy;
- PAC does not regard the specific examples cited by the policyholder as representing incomplete records, and in particular they do not impair PAC's ability to pay the policyholder's annuity or service their policy; and

- In the event that specific information that affected the servicing of a policy after the transfer was identified as being missing, then PAC and Rothesay would work together to attempt to identify and locate the information.

13.60 PAC has also shared with me the results of an exercise undertaken by a third party in January 2018 in the run-up to the initial transaction with Rothesay (i.e. the Business Transfer Agreement and the Reinsurance Agreement). The scope of this work was for the third party provider to undertake an appropriate level of due diligence on the data and associated administration practices and data extraction procedures relevant to the proposed transaction. The objectives of the exercise included the identification of any issues or processes that could have a material impact on the reliability placed on the data. The findings of the exercise included the following:

- The data held on administration systems is generally of good quality, and some of the issues identified are fairly typical and stem from legacy data transferred from pension schemes or other insurers;
- Few of the findings impact the day to day administration and payment of benefits, and instead the findings generally relate to issues that may lead to some over or under-valuation of benefits or affect the mortality assessments PAC carries out.

The exercise characterised its findings according to colour-based outcomes, ranging from “Blue” (the lowest level of concern) to “Red” (the highest level of concern), via “Green”, “Low Amber” and “High Amber”. There were no findings categorised as “Red”, and only one finding classified as “High Amber” (the second highest level of concern); the High Amber finding did not have a bearing on policy administration and instead related to data used for PAC’s internal mortality analysis. All findings related to ‘General Administration’ were categorised as Blue or Green.

13.61 Finally, I note that, in the event that any information relating to policyholder records was identified as missing or incomplete, and assuming that PAC was unable to locate this information, this would not be a consequence of the transfer and would be an issue whether or not the transfer had taken place.

13.62 The responses and information provided to me by the Companies on this matter have given me comfort that Rothesay is likely to receive adequate policy records to allow it to continue to pay the correct annuity amounts on the correct dates to Transferring Policyholders, and that any shortcomings in the data would not prevent Rothesay from providing a good standard of service to Transferring Policyholders.

Policyholders who are concerned by the divestment from Rothesay of Goldman Sachs and Blackstone in 2017 and 2020 respectively.

13.63 A policyholder expressed concerns over the stability of Rothesay’s investor base given that two shareholders (Goldman Sachs and Blackstone) have divested their stakes in Rothesay in recent years.

13.64 In relation to this, it is to be expected that shareholders of private companies will increase or decrease their stakes from time to time, and no decrease in a shareholder’s stake can take place without another shareholder (or a new shareholder) being willing to increase its stake.

13.65 As no change in ownership of shares in Rothesay Limited has any impact on the regulatory solvency position of Rothesay, the relevance of Rothesay’s shareholders to the Scheme relates principally to the willingness of the shareholders to provide capital to support Rothesay in the future, and I have addressed this point in paragraph 8.95.

Policyholders who are concerned that they will not be provided the opportunity to attend and participate in the 2021 Directions Hearing.

13.66 In general, Court hearings are public and therefore attendance is open to anyone. Participation in Court hearings is a matter for the Court and not for the Independent Expert.

13.67 However, I note that the purpose of the 2021 Directions Hearing is for the Companies to explain their proposed approach to policyholder communications and other such areas, and to seek the Court’s approval for these proposals. In particular, the Court will not consider the merits of the transfer as they relate to whether it is appropriate to sanction the Scheme at the 2021 Directions Hearing.

Policyholders who have expressed doubts over the recognition of a Court order by EEA countries following the UK's exit from the EU[118].

13.68 It is my understanding that, as the proceedings related to the transfer were instituted prior to 31 December 2020 (i.e. the end of the Brexit transition period) as a matter of English law, the Court would continue to have jurisdiction to sanction the transfer of any policies issued by PAC with a state of commitment in the EEA other than the UK ("**EEA Policies**"), provided the Scheme is sanctioned on or before 31 December 2022. As all of the Transferring Policies are subject to English law, the Companies expect such transfer would be effective without any mutual recognition issue arising.

13.69 Further, PAC has confirmed that it has not, as far as it is aware, issued any of the Transferring Policies pursuant to any freedom of services rights and that they were all issued to policyholders in and from the UK. It would therefore be a matter of evidence as to whether any individual policyholder could demonstrate that they were habitually resident in an EEA member state at the time their Transferring Policy was effected (which is the applicable statutory test for whether that policy has a member state of commitment under Part VII FSMA which is not the UK) and hence be an EEA Policy. Even if an individual policyholder were to present evidence to that effect, I understand that the Companies have already obtained the relevant legal certificate from the PRA as to due completion of the EEA aspects of the procedure which mean that, as a matter of English law, the Court would have jurisdiction to sanction the transfer of that policy even if it were an EEA Policy. In addition, it is my understanding that Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast) (the "**Brussels Recast Regulation**") will continue to apply to an English Court order on the basis that the proceedings related to the transfer were instituted prior to 31 December 2020. I understand that the Brussels Recast Regulation provides for the principle of mutual trust and recognition of judgments between courts in the EEA and means that a court in the EEA is obliged to recognise the competence of an English Court and its judgment.

13.70 While it remains possible that a legal challenge could be mounted in specific countries by a Transferring Policyholder claiming that local law ought not to recognise the English Court order, from my perspective as Independent Expert, any such legal challenge represents a risk to the execution of the transfer process for that individual policy, rather than constituting a risk that the transfer would, if implemented, materially adversely affect the interests of any group of policyholders. The Companies take the view that the likelihood that any such challenge would be successful is very small for the reasons given above.

MY REVIEW OF OBJECTIONS RECEIVED

13.71 PAC sent me a brief description of every objection it has received, and I selected a sample of objections for which PAC provided the case file which contained full details of the objection and PAC's response.

13.72 Rothesay sent me the case file for all of the objections that were received from Rothesay policyholders[119] and, owing to the small number of such objections, I reviewed each of these. The case files contained the full details of the objections and Rothesay's responses to them.

13.73 I will continue to review the objections received by the Companies in relation to the Scheme up until the last practical moment prior to the 2021 Sanction Hearing and, where possible, will comment on objections received after the finalisation of this Report in my 2021 Supplementary Report.

13.74 On the basis of my review of the objections received so far, I am satisfied that both companies' responses to this sample of objections were appropriate in tone, language and content, and in particular adequately addressed the

[118] Owing to the legal nature of this objection, the legal details in my response to this objection were developed in consultation with the Companies and their external legal advisers.

[119] 21 objections that Rothesay received were deemed to be directed at PAC and therefore forwarded to PAC. I have treated these as objections received by PAC.

substance of the policyholders' objections. I therefore do not have any concerns around the way in which objections to the proposed transfer have been handled by PAC or Rothesay.

CONCLUSION

13.75 While many of the concerns raised by policyholders are understandable, I do not consider that any of the policyholder enquiries received to date that have been categorised as objections raise any concerns that cause me to change my conclusions in relation to the proposed transfer.

13.76 In all cases policyholders have the right to raise their objections at the 2021 Sanction Hearing, which is scheduled to take place on 8 November 2021.

14. Conclusions

14.1 I am satisfied that the implementation of the Scheme will not have a material adverse effect on:

- The security of benefits of the policyholders of PAC and Rothesay, including the Transferring Policyholders; or
- The reasonable expectations of the policyholders of PAC and Rothesay, including the Transferring Policyholders, including:
    - The reasonable benefit expectations of the policyholders of PAC and Rothesay, including the Transferring Policyholders; and
    - The standards of service, management and governance applicable to the PAC and Rothesay policies, including the Transferring Policies.

14.2 I am satisfied that the Scheme is equitable to all classes and generations of PAC and Rothesay policyholders.

Nick Dumbreck 13 July 2021

Fellow of the Institute and Faculty of Actuaries

Appendix 1: Statement of Independence

On 21 June 2018 the Prudential Regulation Authority approved my appointment as Independent Expert to report on the terms of the Part VII scheme to transfer a large block of non-profit annuity business from The Prudential Assurance Company Limited (“**PAC**”) to Rothesay Life Plc (“**Rothesay**). The work involved in this assignment is referred to as “**Project Laker**”.

I am a partner of Milliman LLP, which is the principal legal entity supporting Milliman’s UK operations. I am based in its UK Life Insurance and Financial Services practice in London. The colleagues supporting me in this work and the peer reviewer of this Report are employees of Milliman LLP. These colleagues and I are collectively referred to in this statement of independence as the “**Milliman Team**”.

None of the Milliman Team holds any policies of either PAC or Rothesay, nor is a member of an occupational pension scheme whose benefits are underwritten by PAC or Rothesay. None of the Milliman Team holds any shares in M&G plc (PAC’s parent company) or Rothesay.

In the period 2018 to 2020, the total work carried out for M&G plc and its subsidiaries[120] worldwide by Milliman represented less than 0.1% of Milliman’s global revenue. During the same period, the total work carried out by Milliman LLP for M&G plc and its subsidiaries represented less than 1.5% of the total revenue of Milliman LLP.

In the period 2018 to 2020, the total work carried out for Rothesay worldwide by Milliman represented less than 0.02% of Milliman’s global revenue. During the same period, the total work carried out by Milliman LLP for Rothesay represented less than 1% of the total revenue of Milliman LLP.

In each case my work as Independent Expert for Project Laker has accounted for the majority of the revenue since 2018. To the extent that Milliman is carrying out other work for M&G plc and Rothesay, it is not financially significant and is unrelated to Project Laker.

By the expected Transfer Date in December 2021, I will have been engaged in Project Laker for 3½ years, although my involvement during that time has not been continuous. I note that this is well short of the period for which audit partners and non-executive directors are entitled to be considered independent.

In preparing this Report I have considered afresh all aspects of the proposed transfer, and I have not relied on any of the analysis undertaken in preparing the 2019 Reports. I do not consider that my work on the 2019 Reports has inhibited in any way my ability to act objectively in reviewing the Scheme for the 2021 Court Process.

In conclusion, I do not believe that there is a risk to my ability to act independently in my assessment of the Scheme.

Nick Dumbreck

Fellow of the Institute and Faculty of Actuaries

13 July 2021

[120] For the avoidance of doubt, this includes work carried out for those subsidiaries of the pre-demerger Prudential plc that subsequently became part of M&G plc. It does not include work carried out for other parts of Prudential plc, as these are no longer part of the same group as PAC.

Appendix 2: Previous transfers for which I have acted as Independent Expert or equivalent

1995: Demutualisation of Provident Mutual

1997: Demutualisation of Norwich Union

1998: Demutualisation of Sanlam (South Africa)

1998: Transfer of the business of GAN Life & Pensions and Aegon UK to Windsor Life

1999: Transfer of business from Northern Assurance to CGU Linked Life

2001: Transfer of the pooled pensions business of Norwich Union Linked Life and General Accident Managed Pension Funds to Morley Pooled Pensions

2004: Transfer of the business of Nascent Life to St James's Place International (Ireland)

2004: Transfer of business from 8 companies within the Aviva Group to Norwich Union Life & Pensions and Norwich Union Annuities

2004: Transfer of business from Allied Dunbar and Zurich Assurance to Eagle Star Life

2005: Transfer of business from Phoenix Assurance, Swiss Life (UK) and Bradford Insurance to Royal & Sun Alliance Linked Insurances

2005: Transfer of annuity business from Phoenix & London Assurance to Canada Life (UK)

2005: Transfer of business from Reassure (UK) and Virgin Money Life to Windsor Life

2005: Transfer of business from Allied Dunbar International Assurance to Zurich International Life (Isle of Man)

2006: Transfer of annuity business from Phoenix Life & Pensions to Prudential Retirement Income Limited

2006: Transfer of business from Halifax Life to Clerical Medical and St Andrew's Life

2006: Transfer of long-term business from GE Frankona Re to Swiss Re Life & Health and Swiss Reinsurance Company

2007: Transfer of business from Swiss Re Life & Health to Swiss Re Europe

2007: Transfer of business from NM Life and NM Pensions to Windsor Life

2008: Transfer of immediate annuity business from Zurich Assurance to Windsor Life

2009: Transfer of business from CGNU Life, Commercial Union Life and Norwich Union Life (RBS) to Aviva Life and Pensions and associated inherited estate reattribution

2010: Transfer of business from Aberdeen Asset Management Pooled Pensions Limited to Aberdeen Asset Management Life and Pensions Limited

2011: Transfer of business from SLFC Assurance (UK) Limited to Sun Life Assurance Company of Canada (UK) Limited

2013: Transfer of the Hong Kong branch business of Prudential Assurance Company Limited to Prudential Hong Kong Limited

2016: Transfer of annuity business from Equitable Life Assurance Society to Canada Life Limited

2017: Transfer of non-profit annuity business from Scottish Equitable plc to Rothesay Life Plc.

2018: Transfer of the majority of BlackRock Life Limited's defined contribution pensions business to Scottish Equitable

2019: Transfer of the business of MGM Advantage Life Limited to Canada Life Limited

Appendix 3: Information relied upon

In addition to discussions (both orally and electronically) with PAC and Rothesay staff, I have relied upon the following principal documents in formulating my conclusions:

- Draft PAC With-Profits Actuary report on the Scheme
- Draft PAC Chief Actuary report on the Scheme
- Draft Rothesay Chief Actuary report on the Scheme
- Draft transfer proposal (containing information on the Companies' proposals in various areas relating to the transfer)
- Documents from PAC and Rothesay containing responses to questions from the Independent Expert
- PAC 2019 ORSA
- Rothesay 2020 ORSA
- Rothesay Capital Management Policy
- PAC Shareholder Risk Appetite framework
- PAC Policyholder communications documents
- Reinsurance Agreement between PAC and Rothesay
- Business Transfer Agreement between PAC and Rothesay
- Financial Impact of Scheme pro forma on Rothesay
- Financial Impact of Scheme pro forma on PAC
- Information on lifetime mortgage approach for PAC and Rothesay
- Information on ground rent investments from Rothesay
- Solvency estimates as at 28 May 2021 for PAC and Rothesay

Appendix 4: Certificate of Compliance

I understand that my duty in preparing my report is to help the Court on all matters within my expertise and that this duty overrides any obligations I have to those instructing me and / or paying my fee. I confirm that I have complied with this duty.

I confirm that I am aware of the requirements applicable to experts set out in Part 35 of the Civil Procedure Rules, the Practice Direction and the Protocol for Instruction of Experts to give Evidence in Civil Claims. As required by Part 35 of the Civil Procedure Rules, I hereby confirm that I have understood my duty to the Court, the Royal Court of Guernsey and the Royal Court of Jersey.

I confirm that I have made clear which facts and matters referred to in my 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.

Nick Dumbreck 13 July 2021

Fellow of the Institute and Faculty of Actuaries

Appendix 5: Glossary of Terms

A glossary of abbreviations used throughout the report is given below.

A

The Appeal	The Court of Appeal process in which the Companies successfully appealed Mr. Justice Snowden's judgment from 2019
Appeal Judgment	Judgment of Sir Geoffrey Vos, Lord Justice David Richards and Sir Nicholas Patten on the Appeal, dated 2 December 2020 (Case number 1236/5/7/15)
APS	Actuarial Profession Standards
Asset Share	A measure of the value of a policy based on actual investment returns earned and expenses incurred by the fund
AVC	Additional Voluntary Contributions
AWP	Accumulating With-Profits

B

BEL	Best Estimate Liability
Blackstone	The Blackstone Group L.P.
BRCC	Board Risk and Capital Committee
Brussels Recast Regulation	Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters
Business Transfer Agreement	The transfer agreement between PAC and Rothesay setting out how the Reinsured Business will be transferred to Rothesay
Buy-In	An insurance policy purchased by a defined benefit pension scheme under which the insurer agrees to reimburse the pension scheme for some or all of the pensions it pays to its members
Buyout	A transaction in which a defined benefit pension scheme transfers some or all of its obligations to pay its members' pensions to an insurance company

C

Counterparty default risk	Counterparty default risk, also known as default risk, is the risk that a party to a contract will default on its contractual obligations
Commutation factor	The amount of lump sum received per £1 p.a. of pension benefit. This factor is used to calculate a policyholder's lump sum benefit if a policyholder chooses to commute some or part of their pension income
The Companies	PAC and Rothesay
The Court	High Court of Justice of England and Wales
CPI	Consumer Prices Index
Credit Risk	The risk of losses arising from the default or downgrade of asset counterparties, or from an increase in the perceived risk of default or downgrade of such asset counterparties
CRO	Chief Risk Officer
CSA	Capital Support Arrangement
CWP	Conventional With-Profits

D

Default Risk	The risk that the issuer of a fixed interest asset (e.g. a bond) fails to meet their obligations

Deferred Pension/Annuity	The situation where a pension scheme member/policyholder who is not yet receiving their pension, but is no longer accruing pension benefits within the pension scheme
The Demerger	The demerger of the UK and European savings and investment business of the Prudential Group from the rest of the Prudential Group, resulting in the creation of M&G plc
Directions Hearing	An initial Court hearing at which the companies' plans for notifying policyholders of the Scheme are considered
2019 Directions Hearing	The Directions Hearing that took place on 31 January 2019 as part of the 2019 Court Process
2021 Directions Hearing	The Directions Hearing for the Scheme that will take place on 23 July 2021
Discovery	Discovery Limited
Downgrade Risk	The risk that the credit rating of a bond (or bond issuer) is downgraded

E

EEA	European Economic Area
EEA Policy	Policy with a state of commitment in the EEA other than the UK
Effective Value Test	Diagnostic test set out in PRA Supervisory Statement 3/17 and used by the PRA to identify insurers who may be deriving an inappropriately large Matching Adjustment benefit from lifetime mortgages
EIOPA	The European Insurance and Occupational Pensions Authority
EIOPA Recommendations	EIOPA report on “Recommendations for the insurance sector in light of the United Kingdom withdrawing from the European Union”, dated 19 February 2019
ELAS	The Equitable Life Assurance Society
Excluded Policies	Policies in scope to be transferred by the Scheme which are not able to be transferred on the Transfer Date
Expense Risk	The risk of loss caused by the fact that the timing and/or the amount of expenses incurred differs from those expected
Exposure	The amount of BEL, gross of reinsurance, covered by the longevity reinsurance
EU	European Union

F

FCA	Financial Conduct Authority
FCA Guidance	SUP 18 and FG18/4
FG18/4	Final Guidance 18/4 - “The FCA’s approach to the review of Part VII insurance business transfers”
FG21/1	FCA’s finalised guidance 21/1 - “Guidance for firms on the fair treatment of vulnerable customers”
FOS	Financial Ombudsman Service
FRR	Financial Resources Requirement
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
Fundamental Spread	Adjustment within the determination of the Matching Adjustment, prescribed by the PRA, that represents default and downgrade risk on assets within Matching Adjustment Portfolios

G

GIC	Government of Singapore Investment Corporation
Goldman Sachs	The Goldman Sachs Group, Inc.
Goneaways	Policies where the company does not have a valid address for the policyholder or pension scheme and subsequent reasonable attempts to trace the policyholder or scheme have been unsuccessful
Guernsey Policies	Transferring Policies which were issued to residents of the Bailiwick of Guernsey
Guernsey Scheme	The Guernsey court-approved process that, together with the Scheme, will effect the transfer of certain Guernsey Policies of PAC to Rothesay

H

Court	The Court of Justice in England and Wales
Court Judgment	Judgment of Mr. Justice Snowden relating to the 2019 Court Process, dated 16 August 2019 (Case number CR-2018-003686)
2019 Court Process	Court process that took place in 2019 leading up to the Court Judgment
2021 Court Process	The Court process that will be followed in 2021 to reconsider the Scheme
HMRC	HM Revenue & Customs

I

In-payment pension/annuity	A pension/annuity that is being paid to the member/policyholder
Interest Rate Risk	The risk of loss caused by changes in the level of market interest rates
Internal Model	The PAC internal model for Solvency II reporting

J

Jersey Policies	Transferring Policies which were issued as part of the business carried on by PAC in or from within Jersey
Jersey Scheme	The Jersey court-approved process that, together with the Scheme, will effect the transfer of certain Jersey Policies of PAC to Rothesay

L

Leasehold Reform	The programme of legislative changes being pursued in England and Wales by the UK Government in relation to leasehold properties
Liquidity Risk	The risk of being unable to meet financial obligations as they fall due. Liquidity risk may arise due to illiquidity of the assets held to meet the cash flow requirements, but also due to insufficient funds being available to meet cash flow requirements
Longevity Risk	The risk of loss resulting from changes in mortality rates whereby a decrease in mortality rates causes an increase in the value of insurance liabilities
Longevity Swap	A transaction in which a pension scheme (or an insurer) transfers some or all of the Longevity Risk on its pensions (or annuities) to an insurance (or reinsurance) company

M

2019 Main Report	My main report on the Scheme for the 2019 Court Process, dated 21 January 2019
MAL	MetLife Assurance Limited
MassMutual	MassMutual Financial Group
Master Trust	A Master Trust is a multi-employer occupational scheme where each employer has its own division within the master arrangement

Matching Adjustment	An increase to the discount rate used in the calculation of the BEL that allows firms to take credit for the additional investment return in excess of the risk free rate (swap rates under Solvency II) that they expect to earn from a "hold to maturity" investment strategy. Its effect is to reduce the market value of the assets that must be held by an insurer to cover its Technical Provisions and Solvency Capital Requirement
Matching Adjustment Portfolio	An identifiable portfolio of liabilities (and associated backing assets) to which the insurer has approval to apply the Matching Adjustment
Market Risk	The risk of loss caused by market prices or volatilities of market prices differing from their expected values
MCR	Minimum Capital Requirement
Milliman	Milliman LLP

N

NNEG	No-negative-equity guarantee
Non-Transferring Reinsured Policies	Policies in scope of the Reinsurance Agreement which are not in scope to be transferred under the Scheme

O

Operational Risk	The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events
ORSA	Own Risk and Solvency Assessment. A requirement under Solvency II whereby insurers must regularly undertake a forward looking assessment of risks, solvency needs and adequacy of capital resources
Own Funds	The excess of assets over liabilities under Solvency II

P

PAC	The Prudential Assurance Company Limited
PAC DCPSF	The PAC Defined Charge Participating Sub-Fund
PAC general insurance business	The PAC shareholder-backed short-term insurance business
PAC NPSF	The PAC Non-Profit Sub-Fund
2019 PAC Policyholder Pack	The pack which was sent to holders of Transferring Policies in 2019 as part of the 2019 Court Process, which included a policyholder letter, a summary of the Scheme, a summary of the conclusions from my 2019 Main Report and some specimen Questions and Answers
2021 PAC Policyholder Pack	The pack which will be sent to holders of Transferring Policies which includes a policyholder letter, a summary of the Scheme, a summary of the conclusions from this report and some specimen Questions and Answers
PAC Shareholder-Backed Business	The business of PAC and its subsidiaries outside PAC's ring-fenced with-profits sub-funds
PAC SHF	The PAC Shareholder Fund
PAC With-Profits Fund	The business of PAC within PAC's ring-fenced with-profits sub-funds.
PAC WPSF	The PAC With-Profits Sub-Fund
PAL	Prudential Annuities Limited
PANL	Prudential (AN) Limited
Partial Internal Model	A model which is used to calculate some components of the SCR that is bespoke to an individual company
Paternoster	Paternoster UK Limited

PAYE	Pay As You Earn
PCLS	Pension Commencement Lump Sum
Pension Mis-Selling Costs Assurance	PAC's assurance that mis-selling compensation costs will not affect the bonus or investment policy for policies within the with-profits fund that were in force at 31 December 2003
Persistency risk	The risks of losses caused by deviations of the actual rate of policyholders lapsing their policies from their expected rates
PHLL	Prudential Holborn Life Limited
PIA	Prudential International Assurance plc
PIM	Partial Internal Model
PPFM	Principles and Practices of Financial Management
PPL	Prudential Pensions Limited
PRA	Prudential Regulation Authority
PRA Policy Statement	**"**Statement of Policy - The Prudential Regulation Authority's approach to insurance business transfers", April 2015
PRIL	Prudential Retirement Income Limited
Project Laker	Internal project name for the work carried out by the Companies on the Reinsurance Agreement and the Scheme
Prudent Person Principle	Principle pursuant to Article 132 of the Solvency II Directive requiring insurers to, inter alia, ensure that all assets, in particular those covering the Minimum Capital Requirement and the Solvency Capital Requirement, are invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole

R

RAL	Rothesay Assurance Limited
Regulatory Guidance	The guidance set out in the PRA Policy Statement and in the FCA Guidance
Reinsurance Agreement	A collateralised reinsurance arrangement between PAC and Rothesay signed on 14 March 2018 (as amended) which transferred the policyholder benefit liabilities of the Reinsured Business from PAC to Rothesay
Reinsured Business	Approximately 384,000 (as at 31 December 2020) PAC non-profit annuities which PAC agreed to sell to Rothesay. These policies are covered by the Reinsurance Agreement
2019 Reports	My 2019 Main Report, my 2019 Summary Report and my 2019 Supplementary Report
Risk-free rate	Theoretical rate of return of an investment with zero risk. Risk-free rates are published by the PRA
Risk Margin	An adjustment designed to bring the Technical Provisions up to the amount that another insurance or reinsurance undertaking would be expected to require in order to take over and meet the insurance obligations in an arm's length transaction
RMF	Risk Management Framework
Rothesay	Rothesay Life Plc
Rothesay HoldCo	Rothesay HoldCo UK Limited
2019 Rothesay Policyholder Letter	The letter which Rothesay sent to its policyholders in 2019 to notify them of the proposed transfer
2021 Rothesay Trustee Letter	The letter on the transfer that Rothesay plans to send to trustees of pension schemes that have entered into buy-in transactions with Rothesay since the 2019 Rothesay Policyholder Letter was issued

RPI	Retail Prices Index

S

SAIF	The Scottish Amicable Insurance Fund
SAL	Scottish Amicable Life plc
Sanction Hearing	A hearing of the Court to approve the terms of the Scheme prior to effective date of the Scheme
2019 Sanction Hearing	The Sanction Hearing that took place in 2019 as part of the Scheme
2021 Sanction Hearing	The Sanction Hearing that will take place in November 2021 as part of the Scheme
Scheme	The proposed scheme and all proposals included in the scheme, including any documents referred to in the scheme relating to its proposed implementation and operation
SCR	Solvency Capital Requirement
SCR Coverage Ratio	Own Funds divided by SCR
SFCR	Solvency and Financial Condition Report
SHF	Shareholders' fund
SHIFT	Shareholders' interest in future transfers (from the PAC With-Profits Fund)
SMF	Senior Management Function
SM&CR	Senior Managers and Certification Regime
Solvency I	The prudential regulatory regime applicable to UK insurers prior to 1 January 2016
Solvency II	Regulatory solvency framework for the European Economic Area insurance and reinsurance industry, which continues to apply in materially the same form in the UK
Solvency intervention ladder	Part of PAC's SRA Framework which sets out solvency triggers to consider and initiate actions to manage and restore the capital position as solvency deteriorates
Spread Risk	The risk of loss due to a deviation of the actual market price of credit risk from the expected price of credit risk.
SRA	Shareholder Risk Appetite
SS3/17	The PRA's Supervisory Statement 3/17: "Solvency II: Illiquid unrated assets"
Standard Formula	EIOPA prescribed method of determining the SCR.
2019 Summary Report	An abbreviated version of my 2019 Main Report, prepared for policyholders interested in understanding the transfer but who may not have wished to read the 2019 Main Report in its entirety
2021 Summary Report	An abbreviated version of this Report, prepared for policyholders interested in understanding the transfer but who may not wish to read this Report in its entirety
SUP	Supervision Manual contained in the FCA Handbook
SUP 18	Chapter 18 of the Supervision Manual contained in the FCA Handbook
Supplemental Agreement	The agreement between PAC and Rothesay which modifies the Business Transfer Agreement
2019 Supplementary Report	A further report that was produced prior to the 2019 Sanction Hearing to provide an update for the Court on my conclusions in the light of any significant events subsequent to the date of the finalisation of my 2019 Main Report
2021 Supplementary Report	A further report that will be produced prior to the 2021 Sanction Hearing to provide an update for the Court on my conclusions in the light of any significant events subsequent to the date of the finalisation of this Report

T

TAS	Technical Actuarial Standards

TCFD	Task Force on Climate-related Financial Disclosures
TCS	Tata Consultancy Services
Technical Provisions	Pillar 1 liabilities under Solvency II consisting of BEL and Risk Margin
TMTP	Transitional Measure on Technical Provisions. The TMTP is intended to phase in (over 16 years) any increase in reserves that must be held for business written prior to 2016 arising from the introduction of the Solvency II regime on 1 January 2016
Transfer Date	The effective date of the Scheme which is expected to be 15 December 2021
Transferring Business	The Transferring Policies, together with the associated assets and liabilities which will be included in the proposed transfer to Rothesay
Transferring Policies	The policies of PAC transferring to Rothesay under the Scheme
Transferring Policyholders	Holders of Transferring Policies.
TRASP	The FCA's Thematic Review of Annuity Sales Practices
TRASP Incremental Liabilities	Augmented existing annuity payments as a result of PAC's TRASP PBR
TRASP Lump Sums	Lump sum compensation payments paid by PAC as a result of its TRASP PBR
TRASP PBR	TRASP Past Business review that PAC conducted
TSA	Transitional Services Agreement

U

Unallowable purpose	A corporation tax purpose which is not amongst the business or other commercial purposes of the company

V

Volatility Adjustment	An increase to the discount rate used in the calculation of the BEL (other than for liabilities that are subject to the Matching Adjustment) which aims to prevent forced sales of assets in the event of extreme bond spread movements. Its effect is to reduce the market value of the assets that must be held by an insurer to cover its Best Estimate Liabilities

W

With-profits Advisory Arrangement	An independent person or one or more non-executive directors appointed to provide independent judgement to the insurer's governing body
WPA	With-Profits Actuary
WPC	With-Profits Committee

Appendix 6: Compliance with Regulatory Requirements

The table below indicates how I have complied with the provisions of the PRA Policy Statement and FG18/4 that pertain to the form of the scheme report.

PRA Policy Statement Reference	Requirement	Scheme Report paragraph reference
2.30 (1)	Who appointed the independent expert and who is bearing the costs of that appointment	1.5, 1.23
2.30 (2)	Confirmation that the independent expert has been approved or nominated by the appropriate regulator.	1.5
2.30 (3)	A statement of the independent expert's professional qualifications and (where appropriate) descriptions of the experience that fits him for the role	1.20, 1.21
2.30 (4)	Whether the independent expert, or his employer, has, or has had, direct or indirect interest in any of the parties which might be thought to influence his independence, and details of any such interest	1.22
2.30 (5)	The scope of the report	1.5, 1.16, 1.17, 1.34 to 1.38, 3.1 to 3.19
2.30 (6)	The purpose of the scheme	7.2
2.30 (7)	A summary of the terms of the scheme in so far as they are relevant to the report	7.4 to 7.42
2.30 (8)	What documents, reports and other material information the independent expert has considered in preparing his report and whether any information that he requested has not been provided	Appendix 3
2.30 (9)	The extent to which the independent expert has relied on: (a) information provided by others; and (b) the judgment of others	1.27, 3.22 to 3.25
2.30 (10)	The people on whom the independent expert has relied and why, in his opinion, such reliance is reasonable	3.22 to 3.25
2.30 (11)	His opinion of the likely effects of the scheme on policyholders (this term is defined to include persons with certain rights and contingent rights under the policies), distinguishing between: (a) transferring policyholders; (b) policyholders of the transferor whose contracts will not be transferred; and (c) policyholders of the transferee	8.194, 9.49, 10.32, 14.1, 14.2
2.30 (12)	His opinion on the likely effects of the scheme on any reinsurer of a transferor, any of whose contracts of reinsurance are to be transferred by the scheme	12.46 to 12.49
2.30 (13)	What matters (if any) that the independent expert has not taken into account or evaluated in the report that might, in his opinion, be relevant to policyholders' consideration of the scheme	1.16
2.30 (14)	For each opinion that the independent expert expresses in the report, an outline of his reasons.	Sections 8 to 13
2.32 (1)	The summary of the terms of the scheme should include a description of any reinsurance agreements that it is	7.24

	proposed should pass to the transferee under the scheme	
2.32 (2)	The summary of the terms of the scheme should include a description of any guarantees or additional reinsurance that will cover the transferred business or the business of the transferor that will not be transferred	7.17 to 7.22
2.33 (1)	The independent expert's opinion of the likely effects of the scheme on policyholders should include a comparison of the likely effects if it is or is not implemented	Sections 8 through 13
2.33 (2)	The independent expert's opinion of the likely effects of the scheme on policyholders should state whether he considered alternative arrangements and, if so, what	1.16
2.33 (3)	The independent expert's opinion of the likely effects of the scheme on policyholders should, where different groups of policyholders are likely to be affected differently by the scheme, include comment on those differences he considers may be material to the policyholders	Sections 8 through 13
2.33 (4)	The independent expert's opinion of the likely effects of the scheme on policyholders should include his views on: (a) the effect of the scheme on the security of policyholders' contractual rights, including the likelihood and potential effects of the insolvency of the insurer; (b) the likely effects of the scheme on matters such as investment management, new business strategy, administration, expense levels and valuation bases in so far as they may affect: (i) the security of policyholders' contractual rights; (ii) levels of service provided to policyholders; or (iii) for long-term insurance business, the reasonable expectations of policyholders; and (c) the cost and tax effects of the scheme, in so far as they may affect the security of policyholders' contractual rights, or for long-term insurance business, their reasonable expectations	8.102, 8.103, 8.145, 8.161, 8.187, 8.192, 0, 9.28, 9.31, 9.41, 9.47, 10.12, 10.21, 10.30, 10.24
2.35 (1)	For any mutual company involved in the scheme, the report should describe the effect of the scheme on the proprietary rights of members of the company, including the significance of any loss or dilution of the rights of those members to secure or prevent further changes which could affect their entitlements as policyholders	N/A
2.35 (2)	For any mutual company involved in the scheme, the report should state whether, and to what extent, members will receive compensation under the scheme for any diminution of proprietary rights	N/A
2.35 (3)	For any mutual company involved in the scheme, the report should comment on the appropriateness of any compensation, paying particular attention to any differences in treatment between members with voting rights and those without.	N/A
2.36 (1)	For a scheme involving long-term insurance business, the report should describe the effect of the scheme on the nature and value of any rights of policyholders to participate in profits	12.73 to 12.76

2.36 (2)	For a scheme involving long-term insurance business, the report should, if any such rights will be diluted by the scheme, how any compensation offered to policyholders as a group (such as the injection of funds, allocation of shares, or cash payments) compares with the value of that dilution, and whether the extent and method of its proposed division is equitable as between different classes and generations of policyholders;	N/A
2.36 (3)	For a scheme involving long-term insurance business, the report should describe the likely effect of the scheme on the approach used to determine: (a) the amounts of any non-guaranteed benefits such as bonuses and surrender values; and (b) the levels of any discretionary charges	9.43 to 9.45
2.36 (4)	For a scheme involving long-term insurance business, the report should describe what safeguards are provided by the scheme against a subsequent change of approach to these matters that could act to the detriment of existing policyholders of either firm	12.79 to 12.82
2.36 (5)	For a scheme involving long-term insurance business, the report should include the independent expert's overall assessment of the likely effects of the scheme on the reasonable expectations of long-term insurance business policyholders	8.193, 9.48, 10.31, 14.1
2.36 (6)	For a scheme involving long-term insurance business, the report should state whether the independent expert is satisfied that for each firm the scheme is equitable to all classes and generations of its policyholders	14.2
2.36 (7)	For a scheme involving long-term insurance business, the report should state whether, in the independent expert's opinion, for each relevant firm the scheme has sufficient safeguards (such as principles of financial management or certification by a with-profits actuary or actuarial function holder) to ensure that the scheme operates as presented.	12.79 to 12.82

FCA FG18/4 reference	Requirement	IE Report paragraph reference
6.2	Report is constructed in such a way that it is easily readable and understandable by all its users, paying attention to the following: • Technical terms and acronyms should be defined on first use. • There should be an executive summary that explains, at least in outline, the proposed transfer and the IE's conclusions. • The business to be transferred should be described early in the report. • The detail given should be proportionate to the issues being discussed and the materiality of the Transfer when viewed as a whole. While all material issues must be discussed, IEs should try to avoid presenting reports that are disproportionately long. • IEs should prepare their reports in a way that makes it possible for non-technically qualified readers to understand.	Throughout Section 2 1.1, 2.2 to 2.6 No specific reference No specific reference
6.3	Report must consider and compare: • Reasonable benefit expectations (including impact of charges). • Type and level of service (including claims handling). • Management, administration and governance arrangements.	8.161, 9.41, 9.47, 10.30 8.187, 8.192, 9.31, 10.24 8.192, 9.31, 10.30
The level of reliance on the Applicants assessments and assertions		
6.6	Question the adequacy of assessments carried out by Applicants before relying on them to reach own conclusions (including requesting additional work and evidence from Applicants in order to support their assertions).	No specific reference
6.7	Explain the nature of any challenges made to the Applicants and the outcome of these within the IE report, rather than just stating the final position.	No specific reference
6.8	Where conclusions are supported solely or largely by statements such as 'I have discussed with the firm's management and they tell me that…' followed by 'I have no reason to doubt what they have told me…', then: • Where a feature of the proposed transfer forms a significant part of the IE's own assessment of the Scheme's impact, the IE should review relevant underlying material, rather than relying on the Applicants' analysis of the material and subsequent assertions. • If there are concerns about matters that fall outside the IE's sphere of expertise, such as legal issues, the Applicants must provide the IE with any advice that they have received. If the issue is significant or remains uncertain, the IE must ensure that the Applicants had obtained appropriate advice from a suitably qualified independent subject matter expert.	N/A N/A
6.9	IE has challenged calculations carried out by the Applicants if there is cause for doubt on review of the Scheme and supporting documents. As a minimum, the IE should: • review the methodology used and any assumptions made to satisfy themselves that the information is likely to be accurate and to challenge it where appropriate • challenge the factual accuracy of matters that, on the face of the documents or considering the IE's knowledge and experience, appear inconsistent, confusing or incomplete	N/A
6.10	Documents provided by the Applicants have been challenged where they contain an insufficient level of detail or analysis. For example: • Applicants' assertions that service levels will be maintained to at least the pre-transfer standard: IE should include not only details of the Applicant's plans and any gap analyses that have been produced but also include their view of their adequacy. • Change in governance arrangements in the Transferee that may lead to poorer customer outcomes: the IE must review and compare the governance arrangements in the Transferor which produce good customer outcomes (e.g. any committees with conduct responsibilities) within the Transferee's governance arrangements.	

	• Consideration of the strain on resources that may occur post-transfer and that could impact on the service standards of the Transferee's existing customers and/or control over conduct of business risk. The IE report should include a review of relevant management information indicators and related contingency planning.	
Sufficient comparative regulatory framework analysis		
6.11	Where the regulatory framework is different for the Transferor and Transferee, the IE has carried out sufficient analysis of the differences including, where appropriate, taking independent advice.	N/A
6.12	For cross-border transfers ensure there is a sufficiently detailed analysis of regulatory protections post-transfer. This can include:	
	• The extent to which existing regulatory requirements and protections continue, including whether there is continued access to the Financial Ombudsman Service and the Financial Services Compensation Scheme. In the context of EU withdrawal this is expected at least until the point of policy renewal.	N/A
	• The comparative regulatory requirements and conduct protections across any relevant jurisdictions, including but not limited to complaints or compensation bodies compared to the UK.	N/A
	• Post EU Withdrawal, non-UK EEA customers may be subject to the local conduct of business rules regime, which may not include FOS or FSCS issues. In these cases, firms taking proportionate approaches to compare regimes are likely to be accepted. For example a high level analysis may be appropriate, selecting key UK protections for consumers that are not harmonised in the EEA, and that could be relevant to servicing contracts. This could be accompanied by an explanation that a full gap analysis has not been carried out, but that policyholders can contact the Applicants if they are concerned. Some firms are able to continue to service contracts from UK branches to preserve continuity of regime at least until renewal.	N/A
6.13	The IE report must contain a statement describing the two regimes as well as a considered comparison, highlighting points of significant difference that could adversely impact Policyholders. The level of detail to be included must be sufficient for the Court to be in a position to be satisfied.	Section 4
6.14	If the IE's analysis is inconclusive or there are potential conduct risks due to differences in the regulatory framework, we expect to see sufficient explanation of how Policyholders may be affected and the Applicant's proposals to mitigate these risks.	N/A
6.15	When stating that the IE is satisfied by referencing the Scheme, the IE must adequately explain how the features have led to their satisfaction. The IE must include both the evidence and their reasoning.	Section 8 – Section 12
Balanced judgements and sufficient reasoning		
6.16	The IE must state in their report whether they are certain there will be no material adverse impact to Policyholders or whether this is their best judgement, but lacks certainty. In these instances, the IE must consider the following:	
	• Where the IE takes the view that there is probably no material adverse impact, the IE must challenge the Applicants about further work the Applicants could undertake to enable the IE to be satisfied to a greater degree.	N/A
	• The IE should challenge the Applicants in order to gain the necessary level of confidence that their report's conclusions are robust. Applicants and IEs should be aware that they will need to consider how any proposed changes/mitigations will impact all Policyholder groups.	N/A
6.17	The IE must check that the documents they are relying, and forming judgements, on are the most up-to-date available when finalising their report.	Throughout

6.18	If market conditions have changed significantly since the IE's analysis was carried out and they formed their judgement, the Applicants must discuss any changes with the IE and for the IE to update their report as necessary. If the Scheme document has been finalised, the IE should comment in more detail in their Supplementary Report or by issuing supplementary letters to the Court to confirm whether their judgement is unchanged.	12.53 - 12.55
Sufficient regard to relevant considerations affecting Policyholders		
6.19	Consider all relevant issues for each individual group of Policyholders in both firms, as well as how an issue may impact each group. The IE is expected, when giving their opinion, to consider the: • Current and proposed future position of each Policyholder group • Potential effects of the transfer on each of the different Policyholder groups • Potential material adverse impacts that may affect each group of Policyholders, how these impacts are inter-related and how they will be mitigated	Sections 8 - 10
6.20	Consider whether the groups of affected Policyholders have been identified appropriately. For example, this could include instances where certain Policyholder groups' services are provided by an outsourced function which is changing, but other Policyholder groups do not.	7.46 - 7.50
6.21	Review and give opinion on administrative changes affecting Policyholders, including: • Consideration of the impact of an outsourcing agreement entered into by the parties before the Part VII process began, where the administration duty 'moved' from the Transferor to the Transferee in preparation for the transfer. Provide a comparison of the pre and post-outsourced administration arrangements so the IE can clearly review and compare any changes to Policyholder positions and service expectations. • For the case where the IE concludes that because the transfer will not create any change to the administrative arrangements, there will be no material impact on Policyholders: consider what might happen if the Transfer does not proceed and the possibility that the outsourcing agreement could be cancelled, returning the administrative arrangements to the original state. In such circumstances, consider the impact on Policyholders and claimants of the outsourcing agreement as part of the Part VII process.	N/A N/A
6.22	Review and provide opinion on all relevant issues for all Policyholder groups where reinsurance was entered into in anticipation of a transfer: • Some firms pre-empt regulatory scrutiny by buying reinsurance against risks before they begin the transfer process. In these instances, consider if it is appropriate to compare the proposed Scheme with the position the Transferor would be in if they did not benefit from the reinsurance contract. • If the transfer is not sanctioned and the reinsurance either terminates automatically or can be terminated by the Transferee, consider the Scheme as if the reinsurance was not in place.	Section 11 Section 11
6.23	If the IE identifies particular sub-groups of Policyholders whose benefits, without other compensating factors, are likely to be adversely affected, the IE should take into account the Transferor's obligations under Principle 6 (Customers' interests) of the FCA's Principles for Businesses.	N/A
6.24	Ensure there is consideration and analysis of alternatives when a loss is expected for a particular subgroup of Policyholders, even if the IE does not consider this loss to be material.	N/A
6.25	Provide the analysis outlined in 6.24 even if the IE is able to conclude that the Policyholder group as a whole is not likely to suffer material adverse impact, even if a minority may. For example where: • Some Policyholders within a group/sub-group will suffer higher charges post-transfer because the Transferee has a different charging structure.	N/A N/A

	• Some Policyholders within a group/sub-group had free access to helplines that will no longer be available or have a significantly altered service after the transfer.	N/A
6.26	Ensure that no conclusions are reached based on the balance of probabilities and without adequately considering the possible impact on all affected Policyholder groups.	Sections 8 to 10
6.28	Present the consideration, evidence and reasoning to support the IE's opinion that a change due to the Part VII Transfer will not materially adversely impact a group of Policyholders.	Sections 8 to 10
Commercially sensitive or confidential information		
6.29	When considering commercially sensitive information, consider policyholders' interests as the information will not be publically available.	PAC Shareholder Risk Appetite (5.51 - 5.58, 8.72 - 8.88) Pillar 2 (5.43, 6.32)
6.30	In these situations, document the analysis and the information relied upon. Consider sending a separate document with further details, solely for the Court's use and not for public disclosure	Appendix 3
The level of reliance on the work of other experts		
6.31	For large scale and complex insurance business transfers, if relying on the analytical work of other qualified professionals, it is still expected the IE to have carried out their own review of this analysis to ensure they have confidence in, and can place informed reliance on, the opinions they draw from another professional's work.	4.80 to 4.85
6.32	Obtain a copy of any legal advice given to the Applicants. This should be in writing or transcribed, and approved by the advisor. It should also be in a sufficiently final form for the IE to be able to review and rely on it. The IE should reflect this review, and the opinions drawn from the advice, within their report.	12.77 - 12.78
6.33	If referring to factors outside of expertise and relying on advice received by the Applicants, the IE should consider whether or not to obtain their own independent advice on the relevant issue.	3.22 - 3.25
6.34	Consider if the IE needs to obtain separate legal advice, this will depend on the significance and materiality of the issue.	3.22 - 3.25
6.35	Consider whether it is reasonable for the IE to rely on advice and whether their independence is compromised by doing so. Whether or not the legal advisor has acknowledged that it owes a duty of care to the IE will be relevant to this consideration. Depending on how complex the legal issue is, IEs who rely on the Applicants' legal advice and merely state that they have no reason to doubt the advice and/or that it is consistent with their understanding of the position or experience of similar business transfers may be challenged.	3.22 - 3.25
6.36	When deciding whether to obtain independent legal advice, the IE should consider, amongst other things, the following: • The significance of the issue and the degree of potential adverse impacts to Policyholders if the position turns out to be different from that considered likely in the legal advice. • How much the IE relies on the legal advice to reach their conclusions and, if they did not rely on the legal advice, would the report contain too little information to justify the view that there is no material adverse impact? • The difficulty, novelty or peculiarity of the issue to the Applicants' own circumstances. • Applicants' proposals to explain to Policyholders in communication documents the issues involved, any uncertainty, and any residual risks. • Whether, depending on the issue's significance or uncertainty, the Applicants have obtained an adequate level of advice. Where relevant, whether the Applicants have engaged external advisors with the appropriate expertise and qualifications for the specific subject or jurisdiction.	3.22 - 3.25

	• Whether any advice already received is heavily caveated, qualified or there is a significant degree of uncertainty.	
6.37	The IE may need to explain why they consider that they do not need to get independent advice to be adequately satisfied on a point. The IE's assessment should consider whether there are credible alternative arguments that could be made, whether identified in the Applicant's advice or otherwise. Consider where risks are identified with no suggestion about how they can be mitigated, or what the impact on Policyholders may be if the risks do occur. These considerations would allow the IE to consider the worst case scenario of these impacts.	3.22 - 3.25
6.38	Consider the Applicant's contingency plans if the risks identified in the legal advice occur and whether this may create negative consequences for Policyholders.	N/A
6.40	Consider obtaining a legal opinion on whether a transfer involving overseas Policyholders will be recognised in non-EEA jurisdictions. The IE may take that advice into account but there may be some material doubt as to whether a court would adopt the approach set out in the advice. In that case, the IE should not use such advice as the sole basis of their conclusion that there are no materially adverse effects. IE should consider and be satisfied of the position if the advice turns out not to be the position taken by the relevant court. The legal advice itself should address this and suggest ways of mitigating this risk.	N/A
6.41	If the IE is uncertain, for example, because the legal advice is heavily qualified or uncertain and cannot form a conclusion on an issue. In this case, they may wish to get their own independent legal advice to ensure they can reach a more considered conclusion.	N/A
6.42	The position may be different depending on whether the Transferor remains authorised/in existence. So: • If the Transferor's authorisations are to be cancelled and it could wind up or is planning to do so eventually, acceptable mitigations include the Transferee making a deed poll which is directly enforceable by Policyholders in either the UK or the relevant jurisdiction. It is unlikely that treating these policies as excluded policies is itself an adequate mitigation. Even if the IE has received advice that, even if the Scheme is not formally recognised in another jurisdiction, the Courts of that jurisdiction would still act to prevent the Transferee from denying that it is liable, the IE should still assess any material possibility, and any mitigations if it is not • Where the Transferor is expected to remain in existence for the foreseeable future, the position is less likely to have an adverse impact. This is because Policyholders will still be able to claim against the Transferor as an excluded policy. The IE should still examine what possible material adverse impact this could have on policyholders. For example, any delay in dealing with claims, and any risk that the Transferor changes their approach to dealing with claims because of uncertainty around the Transferee indemnifying the Transferor in full. Mitigations could include some clear commitment be both Transferor in full. Mitigations could include some clear commitment by both Transferor and Transferee in the Scheme, enforceable be Policyholders claims will not be affected or delayed because of the excluded policy and indemnity arrangements.	N/A
6.43	How the IE satisfied themselves about the identified uncertainty and formed an opinion on any potential impact.	Sections 8 to 10
6.45	At the start of the document, the IE should provide a description of where they propose to rely on information provided by the Applicants. Overly general reliance will indicate a lack of critical assessment or challenge.	1.16, 1.27
6.47	If the report does not reach a clear conclusion, either generally or on a specific issue, the IE report should state clearly: • That the IE has considered and is satisfied about the likely level of impact on a particular point. Where uncertainty remains, the IE report needs to include details of, and reasons for, this uncertainty as well as any further steps the IE has taken to get clarification, such as seeking further advice from a subject matter expert.	N/A

	• How the IE satisfied themselves about the identified uncertainty and formed an opinion on any potential impact.	N/A
Demonstrating challenge		
6.48	To ensure the IE report is complete and considered there should be challenge from all involved parties. Including evidence that Applicants have made appropriate challenges, particularly when believed that the IE has not fully addressed issues. Applicants have an interest in ensuring that the Court, regulators and Policyholders are able to rely on the IE report, taking into account to the IE's disclaimers. Applicants should make the challenges without compromising the IE's independence. It should be confirmed that the near-final version of the IE's report had the relevant challenge at the time it was submitted.	Confirmed
6.49	To ensure effective two-way challenge it is expected the IE engages with FCA or PRA approved persons of sufficient seniority at the Applicant firm, such as senior actuaries, including possibly the Chief Actuary, the Chief Financial Officer, Senior Underwriters and so on.	Confirmed
6.50	IEs who are members of the Institute & Faculty of Actuaries should pay proper regard to the Technical Actuarial Standards (TAS) published by the Financial Reporting Council,10 particularly those for compiling actuarial reports.	1.32 - 1.33
6.51	IEs should be aware of TAS (TAS 100: Principles for Technical Actuarial Work and TAS 200: Insurance) specifically apply to technical actuarial work to support Part VII Transfers.	1.32 - 1.33
6.52	Ensure compliance with paragraph 5 of TAS 100 which states that actuarial communications should be 'clear, comprehensive and comprehensible so that users are able to make informed decisions understanding the matters relevant to the actuarial information' and to paragraph 5.2 of TAS 100 which states that 'the style, structure and content of communications shall be suited to the skills, understanding and levels of relevant technical knowledge of users'.	Throughout
6.53	Actuarially qualified IEs and peer reviewers should also bear in mind the Actuaries' Code and Actuarial Profession Standards documents APS X2: Review of Actuarial Work and APS L1: Duties and Responsibilities of Life Assurance Actuaries.	Confirmed
Review of the communications strategy		
7.3	IEs should include consideration of the proposed communications strategy and any supporting requests for dispensations from the Transfer Regulations in their report. There should be evidence that the IE has challenged proposed communications that are not clear and fair and do not adequately explain the transfer and the potential impacts on Policyholders and how these have been addressed.	12.24