



SCOTTISH WIDOWS LIMITED

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Report of the

With-Profits Actuary

on the proposed transfer of the European  
International Life Insurance Business of SWL  
to SWE

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With-Profits Actuary (SWL)

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## REPORT OF THE WITH-PROFITS ACTUARY

### 1 SUMMARY

#### *Purpose*

- 1.1 The purpose of this report is to review the impact on policyholders in Scottish Widows Ltd (“SWL”) (the “Transferor”) of the proposed transfer (the “Transfer”) of
  - Long-term insurance business originally written primarily in Germany, Italy and Austria via International Life Division Europe (“ILDE”) branches;
  - Long-term insurance business originally written via CMI Insurance (Luxembourg) S.A. (“CMIL”);collectively the “Transferring Policies” to Scottish Widows Europe SA (“SWE”)(the “Transferee”).
- 1.2 The Transfer will take effect by means of an insurance business transfer scheme under Part VII of the Financial Services and Markets Act 2000 (“FSMA”), (“the Scheme”). The Scheme Effective Date will be 28 March 2019.
- 1.3 The purpose of this report is to review the potential impact of the proposed Transfer on the security, benefit expectations and servicing of policyholders invested, directly or through reinsurance arrangements, and whether transferring or not transferring, in the Clerical Medical With-Profits Fund (“CM WPF”) or the Scottish Widows With-Profits Fund (“SW WPF”) (collectively referred to as the “policyholders with benefits paid from the WPFs” in this report).
- 1.4 This report does not consider the impact of the Transfer on the transferring or non-transferring policyholders who have no benefits linked to with-profits investments in the SW WPF or CM WPF; the impact on those policyholders will be considered in the SWL Chief Actuary’s Report. This report does not consider any alternative schemes.

#### **Background**

- 1.5 At the point that the United Kingdom (“UK”) leaves the European Union (“EU”) and the European Economic Area (“EEA”), UK insurance companies will no longer be authorised to carry out new business sales in Europe. Furthermore, the European Insurance and Occupational Pensions Authority (“EIOPA”) has indicated that the outcome of the negotiations may also result in the loss of servicing rights for existing inforce business where the policyholder is domiciled not in the UK but one of the other twenty seven EU countries (referred to as “EU27”).
- 1.6 As a result, SWL has chosen to set up a new Luxembourg Insurance company, SWE, into which existing European policies (as described in paragraphs 1.8 and 1.9 below) can be transferred in order to continue to service those policies after the UK has left the EU.

## Report of the With-Profits Actuary (SWL)

- 1.7 SWL is a life insurance subsidiary of Scottish Widows Group Ltd ("SWG") which is itself a subsidiary of Lloyds Banking Group plc ("LBG"), the ultimate parent company. SWL was formed when all of the UK life insurance business of the insurance subsidiaries of SWG was transferred into one company on 31 December 2015. This was accomplished by way of the LBG Insurance ("LBGI") 2015 Scheme ("LBGI 2015 Scheme"). All LBG's UK insurance holdings are collectively referred to as LBGI.
- 1.8 The ILDE policies were originally written through the European branch structures of Clerical Medical Investment Group Limited ("CMIG"). CMIG was the receiving entity under the LBGI 2015 Scheme and was renamed SWL at the time of the transfer.
- 1.9 The CMIIL policies were originally written by a Luxembourg subsidiary of the LBG Insurance Group and were transferred, by Ministerial Decree, to SWL at 31 December 2015.
- 1.10 SWE will be a company domiciled in Luxembourg. It will be a wholly-owned subsidiary of SWL, and will be formed for the express purpose of receiving the Transferring Policies in order that they can continue to be legally serviced in the eventuality that Brexit negotiations result in UK companies losing the right to service policies where the policyholder is domiciled in the EU27.
- 1.11 Discussions have been held with the Luxembourg regulator, the Commissariat aux Assurances ("CAA"), with regards to obtaining authorisation for SWE to undertake insurance business and a final licence application has been submitted. It is expected that the licence will be granted with an effective date of 31 January 2019.
- 1.12 SWE will not be actively seeking new business. It is possible, however that SWE will be used in the future as a receiving entity for any further European business that may need to be transferred from SWL or any European business that forms part of any future acquisitions made by SWL.
- 1.13 SWL will transfer the Transferring Policies via the Scheme into the new insurance company SWE in Luxembourg.
- 1.14 SWL has two WPFs, one that was formerly part of the business of Scottish Widows plc, the SW WPF, and the other that was formerly part of the business of CMIG, the CM WPF. These WPFs are now both held within SWL, separately from each other and from the "Combined Fund", which has all the assets not attributable to the WPFs.
- 1.15 The Transferring Policies are unit-linked and unitised with-profits life and pensions savings products. These products permit the investment of units into a range of SWL's unit-linked funds as well as into the SWL CM WPF.
- 1.16 Some of these Transferring Policies have additional death benefits as well.
- 1.17 A number of the Transferring Policies have the option, or in some cases an obligation, at maturity to vest from pensions savings products and deferred

annuities into a with-profits annuity-in-payment. At 31 December 2017, a very small number of policies had already vested into annuities and these policies will also be transferring. It is expected that this number will grow significantly over time as more policies vest.

- 1.18 Under the Transfer, assets and liabilities, including future liabilities of the Transferring Policies, will transfer to the Transferee from the Transferor. The assets and liabilities so transferred will be determined in accordance with the Scheme.
- 1.19 Under the Transfer, the Transferring Policies will become directly-written business of SWE. The with-profits investment element of the Transferring Policies and any with-profit annuities already in payment at the Scheme Effective Date will be reinsured back to SWL's CM WPF. Future with-profit annuities including the cost of any guarantees related to the conversion of Transferring Policies, whether with-profits or unit-linked, into with-profit annuities will also be reinsured back to SWL.

### ***Key impacts of the Scheme***

- 1.20 I have considered the impact of the Transfer on the policyholders with benefits paid from the WPFs. Key features to note are:
- A key design principle in developing the Scheme and reinsurance arrangement between SWE and SWL has been to ensure that policyholder benefits for Transferring Policies can continue to be determined as they would be if the Transfer were not taking place.
  - The Transferring Policies' terms, conditions and charges will not change as a result of the Scheme.
  - The with-profits investment element of the Transferring Policies and and with-profit annuities in payment liabilities, at the Scheme Effective Date, will be reinsured back to SWL's CM WPF. Future with profit annuities coming into existence due to obligations, or the exercise of options under the Transferring Policies including the cost of any guarantees related to the conversion of Transferring policies (whether with-profits or unit-linked) to with-profit annuities will also be reinsured back to SWL.
  - SWE will withhold the reinsurance premium keeping the assets backing the greater of the Luxembourg Reserves and the Solvency II Best Estimate Liabilities for the reinsured business helping to mitigate SWE from counterparty risk. Of the withheld assets an amount equal to the WP investment Solvency II Best Estimate Liabilities will be withheld from the CM WPF.
  - Transferring with-profit policy benefits will not change as a result of the Transfer (i.e. will continue to be determined in line with the Principles and Practices of Financial Management ("PPFM") of the CM WPF).
  - In addition, a deed of charge, which will be implemented at the time of the Transfer, means SWE's reinsurance arrangement with SWL will rank *pari passu* to (i.e. equal to, and alongside) SWL's direct-written business, in respect of any

policyholder claims over and above the withheld funds, in the unlikely event of SWL insolvency.

- Although SWE will have their own management structure there will be no change to the administration of the Transferring Policies which will continue to be serviced according to the existing outsourcing agreements.
- The liability in respect of overseas litigation risk for the inforce Transferring Policies will transfer to SWE. However, subject to a separate agreement that will be implemented at the time of the Transfer, SWL will provide an indemnity in respect of 90% of this liability.
- The indemnity provided by SWL will also fully protect SWE from any additional losses arising on the Transferring business as a result of conduct or administration prior to the Scheme Effective Date (these losses, if they occurred, would currently be covered by SWL).
- The deed of charge will also result in this indemnity for SWE ranking *pari passu* to (i.e. equal to, and alongside) SWL's direct-written business in the unlikely event of SWL insolvency.
- SWE will be capitalised to the extent that it will maintain a level of capital over and above its regulatory capital requirements. The way in which this excess capital buffer is determined will be similar to how it is currently determined for SWL.

### ***Conclusions on the Scheme***

1.21 I have considered the potential impact of the Scheme on the security, servicing and benefit expectations of the policyholders with benefits paid from the WPFs. Taking into account the key features of the Transfer outlined above, and the discussion of these and other matters contained in the remainder of this report, it is my view that:

- The Transferring Policies, after allowing for the reinsurance arrangement, result in no change to the value of assets and liabilities of the WPFs. The Transferring Policies represent a non-material proportion of SWL's business and the impact of the Transfer on the Non-Transferring Policies will not be material.
- The Scheme will not result in a materially adverse impact on the security and benefit expectations of the policyholders with benefits paid from the WPFs;
- There will be no significant impact on the servicing that any policyholders will receive as a result of the Scheme; and
- The proposed communications plan is appropriate and has paid due regard to the interests of policyholders and the need to treat them fairly, as well as their information needs.

## 2 INTRODUCTION

- 2.1 The purpose of this report is to review the impact of the Scheme on the security, servicing and benefit expectations of the policyholders with benefits paid from the WPFs.
- 2.2 The Transfer will take effect by means of the Scheme.
- 2.3 This report does not consider the impact of the Transfer on the transferring or non-transferring policyholders who have no benefits linked to with-profits investments in the SW WPF or CM WPF; the impact on those policyholders will be considered in the SWL Chief Actuary's Report. This report does not consider any alternative schemes.
- 2.4 This report is written primarily for the Board of SWL in my capacity as With-Profits Actuary ("WPA") for SWL.
- 2.5 This report should be read in conjunction with the Scheme, the report of the Chief Actuary of SWL, and the report of the Independent Expert ("IE").

### ***Status and Disclosure***

- 2.6 I am a Fellow of the Institute & Faculty of Actuaries, having qualified in 1990 and hold a WPA practising certificate issued by the Institute & Faculty of Actuaries. I joined LBG in 2000. Between 1985 and 2000, I worked for Scottish Amicable Life Assurance Society (and subsequently Prudential following its acquisition in 1997).
- 2.7 I am an employee of Scottish Widows Services Limited which is a wholly owned subsidiary of LBG.
- 2.8 I currently act in the Approved Role (under the Solvency II regime, see Section 3 of the Chief Actuary's report for a summary of the Solvency II regime) of WPA for SWL (the parent of SWE).
- 2.9 I have a direct interest in shares of LBG (including share options) and am a member of the Scottish Widows defined benefit pension scheme.
- 2.10 Notwithstanding my holdings described in 2.9, I consider myself to be free from conflict that would prevent me from assessing the impact of the Scheme on policyholder benefits, the security of those benefits and the servicing of those benefits.

### ***Other Advice and Opinions***

- 2.11 In finalising my report, I have reviewed a draft of Mr James Hillman's Chief Actuary's Report on the Scheme. A copy of this report has also been provided to Mr Hillman.
- 2.12 Mr Tim Roff of Grant Thornton UK LLP has been appointed as IE and has been approved as such by the PRA who approved the appointment. In finalising my

report, I have read a draft of his report on the terms of the Scheme and considered his conclusions. A copy of this report has also been provided to Mr Roff.

2.13 In producing this report, I have placed reliance on the following information (amongst other information):

- Assurances expected to be provided by SWE's Board, when in place, with regard to its compliance with the LBG Capital Policy;
- Assurances provided in the Scheme that SWE will follow the decisions made by SWL with regard to bonus declarations, market value adjustments or similar matters (e.g. estate distribution, smoothing etc.) for the Transferring policies;
- Assurances to be provided by SWE's Board, when in place, with regards to the future administration of the Transferring Policies (in particular relating to the servicing levels to be provided to policies and the approach to be taken to reviewable policy charges); and
- The reinsurance arrangement between SWE and SWL.

#### ***Definitions and Abbreviations***

2.14 A list of the defined terms and abbreviations in this report is included in Annex A.

#### ***Compliance with Technical Actuarial Standards***

2.15 This report has been prepared in accordance with, and complies with, the Technical Actuarial Standards 100 and 200.

2.16 In producing this report I complied with the Actuarial Profession Standard ("APS") X1: Applying Standards to Actuarial Work and APS X2: Review of actuarial work.

#### ***Structure of Report***

2.17 This report is structured as follows:

- Section 3 provides an overview of SWL within the wider context of LBGI and provides an overview of the WPFs and the Transferring Policies in particular;
- Section 4 outlines the proposed Scheme;
- Section 5 considers the impact of the Transfer on policyholder security, where benefits are paid from the WPFs;
- Section 6 considers the impact of the Transfer on the benefit expectations of policyholders whose benefits are paid from the WPFs;
- Section 7 considers the impact of the Scheme on taxation, administration, complaints escalation process, governance, cancellation rights and considers the process being adopted to notify policyholders of the intended transfer and court process;
- Section 8 sets out my conclusions;
- Annex A lists the defined terms and abbreviations used in this report.



### 3 OVERVIEW OF SWL AND THE TRANSFERRING BUSINESS

#### **Background**

- 3.1 SWL was formed on 31 December 2015 as a result of the implementation of the LBG 2015 Scheme on that date. The LBG 2015 Scheme is a legal scheme under which seven life insurance subsidiaries of Scottish Widows Group Limited were transferred to an eighth; CMIG – an existing insurance holding of LBG and a subsidiary of SWG. At the time of the transfer CMIG was renamed SWL.

#### **Summary of the Business**

- 3.2 SWL includes two separate with-profits funds, the SW WPF and the CM WPF, and a 'Combined Fund' which holds the assets that are not attributed to the WPFs.
- 3.3 The main categories of business of SWL (with reference to Best Estimate Liabilities held for the business under the Solvency II Regulatory Regime<sup>1</sup>) are summarised in the table below:

*Table 3.1: SWL Best Estimate Liabilities at 31 December 2017*

Business line	Best Estimate Liabilities (£m)
Unit-linked pensions and savings business	81,270
With-profits fund business	15,169
Scottish Widows With-profits fund business	9,997
Clerical Medical With-profits fund business	5,172
Annuities and Other (including protection products providing cover against death, critical illness and sickness)	15,075
Accepted Reinsurance	696
Health Reinsurance	214
Total	112,424

- 3.4 SWL's risk profile includes a mix of market, insurance (i.e. longevity, mortality and morbidity), business (i.e. expense and persistency) and operational risks. SWL holds capital against its risk exposures in line with Regulatory Capital Requirements and internal risk appetite policy.
- 3.5 SWL actively markets new business in the UK.
- 3.6 Additional information on the risks associated with SWL is contained within Section 4 of the Chief Actuary's Report on the Transfer.

#### **Information on SWL's WPFs**

- 3.7 The Clerical, Medical and General Life Assurance Society demutualised on 1 January 1997 and the Scottish Widows Fund & Life Assurance Society

<sup>1</sup> This is the regulatory basis that SWL reported on at 31 December 2017. Further information on this regulatory solvency regime is contained in Section 3 of the Chief Actuary's Report.

demutualised on 3 March 2000. For each company, demutualisation Schemes of Transfer were established, which were binding legal documents approved by the Courts.

- 3.8 These schemes were replaced by the LBGI 2015 Scheme on 31 December 2015, which is also a binding legal instrument approved by the Courts. The LBGI 2015 Scheme governs the operation of SWL, including the With-Profits Funds.
- 3.9 In addition to the LBGI 2015 Scheme, the management of each WPF is also governed by its PPFM. The CM PPFM is published online in English, German and Italian.

#### ***Scottish Widows WPF***

- 3.10 The SW WPF is a separate fund within SWL that contains conventional with-profits policies, the unitised with-profits element of unitised products previously written in the SW Non-Profit Fund, now in the Combined Fund, and some non-profit policies. These policies were written predominantly in the UK.
- 3.11 For some time, the number of new SW WPF policies has been low and so the size of the SW WPF is expected to reduce over time.
- 3.12 The Transferring Policies do not invest in the SW WPF.

#### ***Clerical Medical WPF***

- 3.13 The CM WPF is a separate fund that contains conventional with-profits policies, deposit administration policies, a small number of non-profit policies and the unitised with-profits element of unitised with-profits policies originally written or reinsured into CMIG. These policies were sold in the UK and overseas. Overseas policies are predominantly Euro-denominated, but also include some US Dollar and Sterling denominated business.
- 3.14 This overseas business includes the Transferring Policies that invest in with-profits.
- 3.15 For some time the number of new CM WPF policies being written has been low and so the size of the CM WPF is expected to reduce over time.

#### ***Transferring Policies***

- 3.16 Under the terms of the Scheme, the Transferring Policies will be transferred from SWL to SWE.

3.17 Outsourcing agreements currently exist to service the international business originally written through the ILDE branches and CMIL. These are shown in the table below:

Policies	Serviced by
German & Austrian ILDE Policies	Heidelberger Leben Services Management GmbH
Italian ILDE policies	Information Technology Outsourcing S.R.L
Luxembourg (ex-CMIL) policies	Pack Assurance Management SA

3.18 The Transferring Policies are long-term unitised insurance contracts offering:

- Unitised with-profits investments in SWL's CM WPF;
- Unit-linked investments linked to SWL's unit-linked funds; and
- A few of the above policies that have vested into with-profit annuities-in-payment.

3.19 The unitised with-profits investment products are invested in a series of "Guaranteed Growth Funds" the performance of which determine the bonuses payable to policyholders. The benefits payable also carry underlying guarantees such that the amount payable at defined points (or on death) maybe subject to a minimum value.

3.20 The following table illustrates the actuarial valuation of the insurance liabilities of the Transferring Policies on the Solvency II basis at 31 December 2017.

*Table 3.2: Transferring Policies as at 31 December 2017*

Business category	Number of policies	Best Estimate Liabilities (investment element £m)
With-Profits Benefits	61,408	1,766
Unit-Linked Benefits	26,995	318
<b>Total</b>	<b>88,403</b>	<b>2,084</b>

### **Reinsurance arrangements**

3.21 SWL is party to a number of external reinsurance arrangements. The reinsurance arrangement relevant to the Transferring Policies are two treaties with Swiss Re to cover death benefits and sickness/disability (mainly for waiver of premiums), subject to a minimum retention. At 31 December 2017, the reinsured sum at risk was c£0.3bn and the reinsurance premiums paid for 2017 were c£0.9m.

3.22 These treaties will transfer to SWE under the Scheme.

## 4 OUTLINE OF THE SCHEME IN RELATION TO THE WPFS

### ***Overview of the business transferring***

- 4.1 The Scheme will result in the transfer of the Transferring Policies from SWL to SWE. All liabilities, rights and obligations under the Transferring Policies will transfer to SWE. There will be an associated transfer of assets to SWE. The Scheme is expected to be effected on 28 March 2019.
- 4.2 A key aspect of the Scheme is the requirement that the unitised with-profits investment element and with-profit annuities in payment are reinsured back to SWL. The reinsurance will also cover the future with-profit annuities coming into effect due to obligations, or the exercise of options, under the Transferring policies (whether with-profits or unit-linked) including the costs incurred for any guarantees related to the conversion of the funds into a with-profits annuity. The Scheme sets out the criteria for making changes, or terminating, this reinsurance arrangement to protect policyholders if either such event takes place.
- 4.3 In addition, the Scheme requires an indemnity to be set up between SWL and SWE so that the majority of the exposure to overseas litigation claims remains with SWL.
- 4.4 The Scheme requires that a floating charge arrangement is set up so that SWE ranks *pari passu* (for claims under the reinsurance agreement in excess of the funds withheld, and indemnity liabilities) with the other SWL policyholders in the unlikely event of SWL suffering an insolvency event.
- 4.5 Lastly, to be allowed to make a payment out of the CM WPF the 2015 Scheme has to be updated to allow payments under Part VII Transfers as an allowable payment type.

### ***Assets and liabilities transferring***

- 4.6 Under the Transfer, assets and liabilities will transfer to SWE from SWL. The assets and liabilities so transferred will be determined in accordance with the Scheme.
- 4.7 Alongside the Scheme a reinsurance agreement will be put in place between SWE and SWL covering the with-profit investment element of Transferring Policies pre vesting and the with-profits annuities in payment post vesting. In addition, this reinsurance will cover the future with-profit annuities coming into effect due to obligations, or the exercise of options, under the Transferring policies (whether with-profits or unit-linked) including the costs of any guarantees related to the conversion of the unit funds into a with-profits annuity.
- 4.8 However, SWE will withhold the payment of the premium for this reinsurance. These withheld funds will equal the greater of the Luxembourg Generally Accepted Accounting Principles ("GAAP") Reserves and the Solvency II Best Estimate Liabilities with the assets retained from the CM WPF subject to a maximum of the

WP Solvency II Best Estimate Liabilities excluding any allowance for estate distribution.

- 4.9 Although these withheld assets remain with SWE within the reinsurance agreement there will be an agreement:
- On how these withheld funds can be used to meet claims arising on the reinsured Transferring WP policies;
  - SWL's CM WPF will continue to have the economic benefit from the assets withheld from the CM WPF and can continue to instruct SWE to invest these assets so they are invested in line with the CM WPF's requirements; and
  - That the amount of withheld funds will be reviewed and rebalanced on a quarterly basis.
- 4.10 The quarterly review and rebalancing of the withheld funds is to ensure that SWE continues to withhold an appropriate amount of assets to cover its reinsured liabilities. Any rebalancing requirement would arise as a result of the assumptions on which the liabilities are based being different from actual experience, as well as reflecting any change in that assumption basis during the period.
- 4.11 For the Transferring policies the unit-linked assets underlying the unit-linked funds they invest in will be transferred across into duplicate unit-linked funds set up in SWE. These will operate and be managed in the same way as the SWL unit-linked funds they were pre Transfer.
- 4.12 In addition, a servicing agreement is being put in place with Lloyds Bank so that the box management and unit pricing for these unit-linked funds will continue to operate as they did pre Transfer.
- 4.13 As a result of the indemnity agreement that is being implemented, SWE will be responsible for 10% of the claims related to overseas litigation risk, up to a maximum of €60m. As a result assets covering 10% of SWL's provisions for overseas litigation in respect of the Transferring Policies will transfer to SWE.
- 4.14 Lastly, additional assets required to cover the net of reinsurance Luxembourg GAAP reserves that SWE will have to meet will also transfer from SWL. It is expected that this amount will be paid by transfer of cash or cash type assets.
- 4.15 Alongside the Scheme, at the time of the Transfer there will be a further payment into SWE from SWL in respect of capital. The capital payment will be an amount that ensures that after the Transfer SWE will have sufficient assets to cover its capital policy requirements. The actual amount of the payment will not be confirmed until closer to the time of the Transfer.

#### ***Transferring Policies with With-Profits Investments***

- 4.16 Under the Scheme, the Transferring Policies with investments in the CM WPF will become direct business of SWE and the with-profits investment element for

Transferring Policies pre vesting will then be reinsured back to the CM WPF of SWL.

- 4.17 The reinsurance agreement will also reinsure the future with-profit annuities coming into effect due to obligations, or the exercise of options, under the Transferring policies (whether with-profits or unit-linked) including the costs of any guarantees related to the conversion of the funds into a with-profits annuity to SWL.
- 4.18 Administration and mortality charges will accrue or be charged to SWE based on the policy terms and the terms of the reinsurance arrangement. SWE will correspondingly be responsible for the expenses of administering the business and mortality costs for the policies from which it receives charges.
- 4.19 SWE will withhold assets equal to the greater of the Luxembourg GAAP reserves and the Solvency II Best Estimate Liabilities for the investment element of the Transferring With-Profits policies from the reinsurance premium paid to SWL. This is to provide security for the Transferring Policyholders in the unlikely event of SWL becoming insolvent (this is discussed in paragraphs 5.54 to 5.56).
- 4.20 Of the withheld assets an amount not exceeding the WP Solvency II Best Estimate Liabilities will be withheld from the CM WPF. Under the Reinsurance Agreement SWL's CM WPF will continue to have the economic benefit from these assets and can continue to invest the assets in line with the CM WPF's requirements.
- 4.21 The CM WPF will continue to be a ring-fenced fund in SWL and the way it is run will not change materially as a result of the Transfer (i.e. it will continue to be run in accordance with its PPFM and the LBGI 2015 Scheme).
- 4.22 The SWE Board will be responsible for with-profits bonus setting, determination of market value adjustments or similar matters (e.g. estate distribution, smoothing etc.) for the Transferring Policies with with-profits investments. As confirmed in the Scheme, the SWE Board will resolve that that the bonuses, market value adjustments and similar matters follow the decisions made by SWL in respect of the reinsurance of these policies in all reasonably foreseeable circumstances.

#### **Non-Transferring Policies with investments in CM WPF**

- 4.23 The Non-Transferring Policies with investments in the CM WPF will remain direct business of SWL in the CM WPF. Administration and mortality charges will continue to accrue or be charged to SWL as currently. SWL will continue to be responsible for the expenses of administering the business and mortality costs for the policies from which it receives charges.

## **CM WPF**

- 4.24 The CM WPF will continue to be a ring-fenced fund in SWL and due to the reinsurance agreement:
- The Transferring with-profit policies will be reinsured back into the CM WPF and will be treated as if they had never left for bonus setting, estate distribution etc.;
  - SWE will withhold funds from the CM WPF but those funds can be used to pay claims relating to the Transferring with-profits policies;
  - The CM WPF will continue to have the economic benefit from the assets withheld from the CM WPF and SWL can continue to instruct SWE to invest these assets so they are invested in line with the CM WPF's requirements.
- 4.25 The above means that the way in which the CM WPF is run will not change materially as a result of the Scheme (i.e. it will continue to be run in accordance with its PPFM and the LBG1 2015 Scheme).
- 4.26 In effect, this means that the operation of the CM WPF will be unaffected as a result of the Transfer (other than to the extent to which the Transfer might impact on SWL's ability to maintain its solvency or to the extent to which the reinsurance arrangement between SWL and SWE could be terminated<sup>2</sup>). Paragraph 5.5 below demonstrates that the Transfer has no materially adverse impact on the solvency position of SWL.

### ***Policies with Investments in the SW WPF***

- 4.27 None of the Transferring Policies are invested in, or are able to invest in, the SW WPF.
- 4.28 The SW WPF is unaffected by the Transfer other than any impact on SWL's ability to maintain its solvency.

### ***Policyholder Protection***

- 4.29 As a result of the reinsurance arrangement that will be put in place for SWL to retain:
- the with-profits investment element of pre vesting Transferring Policies;
  - the annuity in payments of post vesting Transferring Policies; and
  - the costs related to any guarantees around the conversion of Transferring Policies (whether with-profits or unit-linked) into with-profits annuities,
- absent a security arrangement, SWE (as a reinsurance creditor) would rank behind the direct policyholders of SWL in the unlikely event that SWL entered

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<sup>2</sup> This is discussed in Section 6.

insolvency proceedings. This would place SWE policyholders at risk of recovering less than they would have had they remained as a direct policyholder of SWL.

4.30 To mitigate this risk two actions are being taken:

- SWE will withhold funds equal to the greater of the Luxembourg GAAP reserves and the Solvency II Best Estimate Liabilities for the reinsured with-profits business from the reinsurance premium paid to SWL; and
- A deed of charge will be put in place at the time of the Transfer so that SWE will rank *pari passu* (i.e. equal to and alongside) with SWL's direct-written business for any claim over and above the withheld funds in the unlikely event of SWL insolvency.

4.31 This deed of charge will mean that if SWL becomes insolvent SWE, as the reinsured party, will have the same creditor ranking for reinsurance claims in excess of the funds withheld, as the Transferring Policies currently have pre Transfer.

4.32 In addition, as there is no Financial Services Compensation Scheme (FSCS) in Luxembourg, as described in paragraphs 5.48 to 5.51, the CAA require that assets equal to the greater of the Solvency II Technical Provisions and the Luxembourg's GAAP reserves are held in a tripartite custodian agreement with the CAA as one of the parties. These assets are held separately to ensure they are available to cover the policyholders' liabilities of SWE in the unlikely event of SWE insolvency.

4.33 The appropriate amount of assets will be put into such an agreement on the Scheme Effective Date.

4.34 The liability in respect of overseas litigation risk for the inforce Transferring Policies will transfer to SWE.

4.35 A separate agreement will be implemented at the time of the Transfer under which SWL will provide SWE with an indemnity in respect of 90% of the overseas litigation liability. The remaining 10% liability will remain with SWE, up to a maximum amount of €60m.

4.36 The indemnity provided by SWL will also fully protect SWE from any additional losses arising on the Transferring business as a result of conduct or administration prior to the Scheme Effective Date.

4.37 As a result of the deed of charge this indemnity for SWE also ranks *pari passu* to (i.e. equal to, and alongside) SWL's direct-written business in the unlikely event of SWL insolvency.

4.38 For the avoidance of doubt the liability in respect of overseas litigation risk for out-of-force Non-Transferring Policies will not transfer to SWE, and hence remain 100% with SWL.



***Costs of implementing the Scheme***

- 4.39 The costs associated with the implementation of the Scheme will be met by the shareholders of SWL (via the Combined Fund). This means that policyholders will not bear any of the costs of the Transfer.

## 5 IMPACT ON POLICYHOLDER SECURITY

- 5.1 This section contains information on the financial impact of the Transfer and covers the particular matters relating to issues that are of relevance to the security of the policies with benefits paid from the WPFs.

### **Financial Impact of the Transfer on Non-Transferring Policies**

- 5.2 As illustrated in Section 3, the Transferring Policies constitute a non-material proportion of SWL's total liabilities after allowing for the reinsurance arrangement (the Solvency II Best Estimate Liabilities of the Transferring Policies being c1.8% of SWL's total Solvency II Best Estimate Liabilities as at 31 December 2017 before allowing for the reinsurance arrangement, and c0.2% after allowing for the reinsurance arrangement).
- 5.3 The Transferring With-Profits Policies are c34% of the CM WPF Solvency II Best Estimate Liabilities before allowing for the reinsurance arrangement but has no impact on the Solvency II Best Estimate Liabilities after allowing for the reinsurance arrangement.
- 5.4 To further illustrate the non-material impact of the Transfer on SWL, the table below summarises the impact of the Transfer on SWL's Solvency II required capital at 31 December 2017. In this, the Working Capital Ratio provides a useful indicator of the immediate impact of the Scheme on the level of benefit security provided to the Non-Transferring Policies based on the Solvency II regime.

Table 5.1: SWL solvency position pre and post Transfer at 31 December 2017

£m	SWL Pre Transfer				SWL Post Transfer			
	SW WPF	CM WPF	Combined Fund	Total	SW WPF	CM WPF	Combined Fund	Total
Available Capital <sup>3</sup>	1,183	395	7,760	8,412	1,183	395	7,592	8,244
Regulatory Capital Requirement	(417)	(235)	(5,361)	(6,014)	(417)	(235)	(5,397)	(6,050)
Working Capital	766	159	2,398	2,398	766	159	2,194	2,194
Working Capital ratio	284%	168%	145%	140%	284%	168%	141%	136%

- 5.5 In this table the SWL Post Transfer results allow for SWE as a subsidiary of SWL by including SWE's Available Capital in SWL's Available Capital and SWE'S Regulatory Capital Requirement in SWL's Regulatory Capital Requirement. The SWE values can be found in Table 5.3.

<sup>3</sup> Note that the Total Available Capital does not equal the sum of the Available Capital of the SW WPF, CM WPF and Combined Fund as SWL is restricted to only recognising the Available Capital in the SW WPF and CM WPF required to meet their respective Regulatory Capital Requirements.

## Report of the With-Profits Actuary (SWL)

- 5.6 This table shows that, had the Transfer taken place at 31 December 2017, while SWL's Working Capital Ratio decreases from 140% to 136% it would have continued to comfortably meet its Solvency II requirements after the Transfer. SWL's Combined Fund's solvency continues to meet SWL's Capital Policy target.
- 5.7 In addition, the table also shows that there is no change in the financial position of the WPFs, other than due to the reduced support available from SWL's Combined Fund due to the reduced Working Capital.

Table 5.2: Movement in SWL solvency position from pre Transfer to post Transfer at 31 December 2017

£m	Pre Transfer	Impact of Removing Transferring Policies <sup>4</sup>	Impact of Creating and Adding SWE Subsidiary	Post Transfer
<b>Available Capital</b>	<b>8,412</b>	(105)	(63)	<b>8,244</b>
<b>Regulatory Capital Requirement</b>	<b>(6,014)</b>	+89	(125)	<b>(6,050)</b>
<b>Working Capital</b>	<b>2,398</b>	(16)	(188)	<b>2,194</b>
<b>Working Capital ratio</b>	<b>140%</b>	0.3%	(3.9)%	<b>136%</b>

- 5.8 This table highlights:
- The low materiality of the Transferring Policies in terms of SWL's current overall business and operation.
  - The inefficiencies in splitting the business into a separate subsidiary; principally arising due to:
    - additional expenses,
    - the introduction of inter-company counterparty exposures,
    - loss of diversification and
    - moving to a Standard Formula measurement of capital requirements and Risk Margin for SWE.

Some of this impact might be mitigated if an Internal Model were to be adopted for SWE and if SWL's current approach of adding in the Available Capital and Regulatory Capital Requirement for subsidiary companies were to be amended to reflect a position where inter-company relationships between SWE and SWL were consolidated out and where risks between SWE and SWL were allowed to diversify against one another.

- 5.9 However, I note that as SWE is a subsidiary of SWL with the exception of the additional expenses related to having a subsidiary, and potentially some capital fungibility issues, as a group SWL is exposed to the same risks post Transfer as it was pre Transfer.

<sup>4</sup> After allowing for the reinsurance agreement and indemnity

- 5.10 It is also noted that, post Transfer, SWL would continue to operate under its existing LBG Capital Policy, Capital Management Plan and Capital Recovery Plan which would allow SWL to look to SWG for capital support<sup>5</sup> if required.

#### **Impact of Funds Withheld by SWE**

- 5.11 For Non-Transferring Policies, there is a potential issue around the funds that SWE withholds. This is mitigated somewhat as these assets relate directly to the liabilities of the Transferring Policies which are reinsured to SWL.
- 5.12 However, the withheld funds means that in the event of insolvency of SWL then either
- a) there are sufficient assets of SWL to meet all of the policyholders' liabilities (but not the lower ranking liabilities) and so there is no impact on the SWL Non-Transferring policyholders from these assets being withheld; or
  - b) there are insufficient assets of SWL to meet all of the policyholders' liabilities and there is a haircut to payouts for SWL policies, and the Transferring policies are potentially benefitting from the fact that assets equal to the greater of the Luxembourg GAAP reserves and the Solvency II Best Estimate Liabilities (excluding allowance for any estate distribution) are withheld by SWE.
- 5.13 In b) above the SWL Non-Transferring policyholders are potentially disadvantaged because as SWL has insufficient assets to meet all policyholder liabilities this leads to a reduction in the Non-Transferring policies' payouts. However, the value of the Transferring Policies' liabilities in relation to SWL liabilities as a whole is c1.8% (as discussed in paragraph 5.2) and so if there was (say) a 10% hair cut to the policyholders' payouts not being able to apply the haircut to the Transferring Policies would result in an extra c0.2% cut to the Non-Transferring Policies.
- 5.14 However, in this scenario the UK's FSCS would meet the reduction in their claim and there is no materially adverse impact on the SWL policyholders.
- 5.15 The above indicates that the Transfer does not have a materially adverse impact on security from the perspective of SWL. I am therefore satisfied that there will be no materially adverse impact on the security of Non-Transferring Policies with benefits paid from the WPFs.

#### ***Financial Impact of the Transfer on Transferring Policies with With-Profits Investments***

- 5.16 In order to assess whether or not the security of the Transferring Policies will be materially adversely affected by the Scheme, it is useful to consider the reported solvency position of SWL before the Transfer against the expected solvency of SWE after the Transfer.

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<sup>5</sup> Although the LBG Capital Policy looks to ensure that all its subsidiaries are adequately capitalised SWG is under no legal obligation to provide the capital support requested.

- 5.17 As part of its risk management approach, SWE will operate a Capital Policy which follows the LBG Capital Policy (as described in Section 6 of the Chief Actuary's Report), both in terms of implementation and scale of target capital buffer.
- 5.18 The table below shows the pre Transfer Solvency II position of SWL and the estimated post Transfer Solvency II position of SWE. As described previously, the Working Capital Ratio provides an indication of the immediate impact of the Scheme on the level of benefit security provided to the Transferring Policies.

Table 5.3: SWL pre Transfer and SWE post Transfer Solvency II position at 31 December 2017

£m	SWL Pre Transfer	SWE Post Transfer
Available Capital	8,412	175
Regulatory Capital requirement	(6,014)	(125)
Working Capital	2,398	50
Working Capital ratio	140%	140%

- 5.19 SWE's Regulatory Capital Requirement in the table above includes an add-on in respect of overseas litigation risk that is not strictly required by the Solvency II Standard Formula. The CAA has indicated that they would be unlikely to require this add-on for the formal Solvency II Pillar 1 regulatory reporting. Hence the Solvency II Pillar 1 regulatory working capital ratio would be higher than the 140% shown above. As SWE intends to hold capital for the overseas litigation risk for Solvency II Pillar 2 capital and risk appetite assessment purposes, we have included it in the table above to provide appropriate comparability.
- 5.20 The results show that, after the Transfer, SWE would more than meet its Solvency II requirements, and would be capitalised to the same Working Capital ratio level as SWL pre Transfer. Note that SWE would be capitalised according to the Standard Formula, which is arguably prudent when compared to the existing Internal Model approach<sup>6</sup>. Therefore there is prudence within the SWE solvency impact shown above.
- 5.21 I also note that as a subsidiary of SWL, and a member of the group headed by SWG, which itself is a subsidiary of LBG, SWE would have the ability to look for support from SWL<sup>7</sup> (and the wider group) if it was breaching its capital management policy

<sup>6</sup> This increase in capital requirement also results in a greater Risk Margin for SWE compared to the same business within SWL.

<sup>7</sup> Although the LBG Capital Policy looks to ensure that all its subsidiaries are adequately capitalised SWL is under no legal obligation to provide the capital support requested.

### **SWE Capital Projection**

5.22 In addition to reviewing SWE's capital position immediately after the Transfer, I have also considered SWE's projected capital position. To do this I reviewed the base projection of SWE's SCR Cover Ratio within its five-year business plan.

5.23 This showed that SWE's SCR Cover Ratio was projected to remain above its Capital Policy requirements throughout the projection period.

### **Sensitivity Testing**

5.24 In addition to the base and projected positions above I have also considered adverse sensitivity testing that has been carried out for SWE. These sensitivities considered the SWE Solvency II balance sheet and Regulatory Requirement after 1 in 20 year events. The sensitivities covered were:

- Increased Expense levels;

This is a one off fixed percentage increase in expenses that then remains for the duration of SWE's business.

- Increased Expense Inflation;

This involves a fixed percentage increase to the level of inflation that is applied to SWE's expenses each year for the duration of SWE's business.

- Counterparty Risk

This sensitivity considers the impact on SWE if SWL, as SWE's main counterparty, has its Credit Rating reduced by one level (from A to BBB based on Standard & Poors). This is actually more severe than a 1 in 20 year event.

- Increase in Lapse Level

This allows for a one off fixed percentage increase in lapse levels experienced each year by the Transferring Policies with SWE.

- A Mass Lapse Event

This is a one off instantaneous lapse by a significant number of Transferring Policies with SWE.

- A one off fall in Equity Values

This is a significant fall in equity values.

5.25 The results for these adverse sensitivities show a decrease in SWE's ability to cover its Regulatory Capital Requirements with one of the sensitivities showing that SWE would no longer be able to meet its Regulatory Capital Requirements.

5.26 This is not unexpected as the LBG Capital Policy is designed for SWE to have a Capital Buffer that will meet a 1 in 10 year event and these are more severe 1 in 20 year events.

- 5.27 Under the majority of these sensitivities SWE would manage its solvency recovery through retaining profits and not paying dividends to SWL. This would result in SWE restoring its Capital Buffer to its target level within a year or two.
- 5.28 The sensitivity that had a larger impact and so requires further discussion is the Increase in Expense Inflation.
- 5.29 Under the increase in expense inflation sensitivity as a result of the relatively large proportion of overhead expenses that SWE has combined with the long duration of its liabilities (due to the anticipated conversion to with-profit annuities-in-payment) SWE can no longer meet its Regulatory Capital Requirements.
- 5.30 In this scenario as well as retention of profits other management actions could include the hedging of further expense inflation risk and/or looking to SWL for capital support<sup>8</sup>. If a hedge of expense inflation was introduced then SWE would meet its Regulatory Capital Requirements. Once in situ the Board of SWE will consider whether to implement such a hedge.
- 5.31 It is also worth noting that under the Counterparty Downgrade sensitivity, in the absence of withheld funds under the reinsurance agreement, SWE would be exposed to the downgrade of SWL as the Solvency II Standard Formula calculation of the Regulatory Capital Requirements allows for a significant increase in the probability of default for a company with a credit rating of BBB rather than A.
- 5.32 This would have resulted in SWE being unable to meet its Regulatory Capital Requirements under the Counterparty Downgrade sensitivity.

***Conclusions on the Financial Impact of the Transfer***

- 5.33 I am therefore satisfied that, taking into account the capital policy of SWE, SWE will be capitalised to a level where the Transfer will not lead to a materially adverse impact on the security of the Transferring Policies with benefits paid from the with-profits funds.
- 5.34 I am satisfied that SWE has appropriate management actions in place to facilitate recovery of its solvency position after significantly (i.e. 1 in 20 year events) adverse events.

***Specific considerations in respect of changes in risk profile that arise from the Transfer and associated introduction of reinsurance arrangement***

- 5.35 Under the Scheme, SWE will not have a ring fenced WPF.
- 5.36 The lack of a ring-fenced WPF is not a significant issue as, under the Scheme, the with-profits investment element and any with-profit annuities in payment, at the Scheme Effective date, of Transferring Policies will be reinsured back to SWL's CM

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<sup>8</sup> Although the LBG Capital Policy looks to ensure that all its subsidiaries are adequately capitalised SWL is under no legal obligation to provide the capital support requested.

WPF. These policies will be treated as if they have never left the CM WPF, e.g. for bonus declarations including estate distribution.

- 5.37 In addition all future with-profit annuities and the cost of any guarantees related to the conversion of Transferring Policies (whether with-profit or unit-linked) to with-profit annuities will be reinsured back to SWL.
- 5.38 The withheld funds by SWE under the Reinsurance Agreement will be held under a tripartite custodian agreement to be available to meet policyholder claims if SWE was to go insolvent and will be separately identifiable from the other assets held under the custodian agreement. As part of the reinsurance agreement SWL will instruct SWE on how these assets should be invested so that they continue to be invested in line with the CM WPF's requirements.
- 5.39 This reinsurance arrangement will be effective from the Scheme Effective Date and can only be altered (other than for minor technical alterations) or terminated if:
- It is agreed by both parties; and
  - A written report has been obtained from an independent actuary stating that policyholders are not materially adversely impacted; and
  - There is no objection from the appropriate Regulators.

Alternatively SWE may terminate the reinsurance arrangement if SWL suffers an insolvency event and no objection to such termination is received from the CAA or PRA (where SWE would retain the withheld funds and an independent actuary would review the appropriateness of the termination amount).

- 5.40 This puts in place an appropriate framework for ensuring that the impact of any future alterations, or termination, of the reinsurance on policyholders, whether Transferring or Non-Transferring, considers the impact on the policyholders and allows an appropriate decision to be made at that time.
- 5.41 As a result of the Transfer and the implementation of this reinsurance arrangement between SWE and SWL, the Transferring Policies with with-profits investment element and with-profit annuities in payment will be:
- a) Exposed to the risk of SWL defaulting on its reinsurance obligations to SWE;
  - b) Exposed to the risk that SWE becomes insolvent, in which case, policyholder recourse would be to the resources of SWE rather than SWL.
- 5.42 However, in respect of a) the reinsurance agreement has SWE withholding the reinsurance premium. This means that if SWL was to default on its reinsurance obligations, these withheld funds would be available for SWE to use to meet policyholder claims.
- 5.43 In addition, alongside the reinsurance agreement and the withheld funds there is a deed of charge (that will be implemented at the time of the Transfer) under which SWE, as the reinsured party, will rank *pari passu* to (i.e. equal to, and alongside) SWL's direct written business in the unlikely event of SWL's insolvency for any payments under the reinsurance agreement due to be made over and above the withheld assets.



5.44 This is intended to provide continued protection for the Transferring Policies in the unlikely event that SWL becomes insolvent.

5.45 It is also worth noting that currently, pre Transfer, the Transferring Policies are exposed to the risks that would cause SWL to default on their reinsurance payments post Transfer.

5.46 In respect of b):

- Prior to the Transfer, the Transferring Policies have recourse to all the resources of SWL. Following the Transfer, the Transferring Policies will be directly written and insured by SWE and will therefore not have direct recourse to the resources of SWL.
- SWE will be capitalised to similar level to SWL pre Transfer, as per paragraphs 5.16 and 5.20, and through its Capital Recovery Plan could look to SWL for capital support<sup>9</sup> if SWE was close to, or below, its Regulatory Capital Requirements.
- As discussed in paragraphs 5.52 to 5.55 Luxembourg regulations require that assets equal to the greater of the Solvency II technical provisions and the Luxembourg GAAP reserves are held under a tripartite custodian agreement so that they are available to meet policyholder claims if SWE becomes insolvent.
- This means the assets backing the policyholder liabilities are protected.

5.47 For the reasons above, I do not believe that the security of the Transferring Policies will be materially adversely affected by the Transfer and the associated removal of direct recourse to the resources of SWL.

### ***Swiss Re Reinsurance***

5.48 The Transferring Policies are currently covered by two reinsurance treaties with Swiss Re.

5.49 The Scheme will transfer these reinsurance treaties to SWE and the Transferring Policies will continue to be covered by them.

### ***Compensation Schemes***

Outline of relevant compensation schemes

5.50 In the UK in the event of liquidation or winding up of an insurance company direct (i.e. not reinsurance) policyholders have preferential rights which overrides any other creditor's rights, except the specific preferred creditors; employees, the treasury, the municipalities, the national social security agencies and the professional bodies.

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<sup>9</sup> Although the LBG Capital Policy looks to ensure that all its subsidiaries are adequately capitalised SWL is under no legal obligation to provide the capital support requested

- 5.51 In addition, there is a Financial Services Compensation Scheme ("FSCS") for customers of authorised financial services firms. This means that FSCS must pay compensation if an insurance company is unable, or likely to be unable, to pay claims against it. FSCS is an independent body, set up under the Financial Services and Markets Act 2000, and is funded by a levy on authorised financial services firms.
- 5.52 Luxembourg has no equivalent of the FSCS. However, the CAA stipulates that the assets backing the technical provisions, based on the higher of Solvency II and Luxembourg GAAP regulations, held for policyholders must be segregated ("Tied Assets") and must be deposited with a credit institution under the conditions defined by the CAA. These assets are allocated specifically for guaranteeing the payments to policyholders. Upon liquidation and wind-up of an insurer, policyholders will be reimbursed by using these segregated assets.
- 5.53 If the separate pool of Tied Assets is not sufficient to cover all insurance claims (e.g. in case of an unexpected depreciation of certain assets), the winding-up of the insurance undertaking may only be carried out via a reduction of the entitlement, on such pool of assets, of the insurance creditors (which includes policyholders), in proportion to the amount of their claim.
- 5.54 In order to reinforce the protection of the insurance creditors there is an additional preferential right for their benefit: where the Tied Assets would not be sufficient in order to satisfy the claims of the insurance creditors in their entirety, the insurance creditors including policyholders retain a preferential right on the other assets of the insurance company.
- 5.55 Such additional preferential right overrides any other creditor's rights, except the specific preferred creditors; employees, the treasury, the municipalities, the national social security agencies and the professional bodies.

#### Implications and conclusion

- 5.56 The Transferring Policies all currently qualify for the FSCS but will lose this protection post Transfer (although if your claim results from an event which occurs prior to the transfer it will continue to be covered by the FSCS).
- 5.57 However, as discussed in Section 6 of the Chief Actuary's Report SWE will hold significant capital over its Regulatory Capital Requirements. SWE targets a Risk Capital Buffer over its Regulatory Capital Requirement sufficient to cover a 1 in 10 year stress event. As a result of holding this buffer in addition to its Regulatory Capital Requirement, SWE would need to suffer significant loss of capital before becoming technically insolvent, i.e. unable to cover its Technical Provisions.
- 5.58 In addition, SWE will have the Tied Assets held in a separate tripartite custodian agreement (with the CAA as one of the parties) and these assets will be available to meet the policyholders' claims. These assets will be the greater of the technical provisions on a Solvency II and Luxembourg GAAP basis, and so are able to meet policyholder's liabilities.

- 5.59 Similar to SWE above, and as discussed in Section 6 of the Chief Actuary's Report and demonstrated by the results earlier in this section, SWL holds a significant Risk Capital Buffer over its Regulatory Capital Requirements. As a result, the risk of SWL becoming technically insolvent (i.e. being unable to cover its Technical Provisions on a Solvency II basis) is highly unlikely.
- 5.60 The risk of insolvency of either SWL or SWE should be reduced further by regular regulatory oversight through which it would be expected that the PRA and CAA, would be made aware by SWL and SWE respectively, through regular management information, of any deterioration in solvency at an early stage and if necessary would take action to protect policyholders.
- 5.61 Finally, the purpose of the Scheme is to allow the continued servicing of the Transferring Policies after Brexit. It is my view that being able to legally service these policies post-Brexit is a much more crucial consideration for Transferring Policies and, in this context, the loss of the FSCS protection is an acceptable consequence.
- 5.62 As a result, I am satisfied the Transferring policyholders will not be materially adversely affected by the Transfer as a result of any changes in eligibility for compensation schemes.

***Conclusions on the security of policyholder benefits payable from the WPFs***

- 5.63 Based on the discussion above, I am satisfied that:
- The Transfer does not have a materially adverse impact on the financial position of SWL and as such does not have a materially adverse impact on the security of the policyholders with benefits paid from the WPFs.
  - Taking into account the coverage of its regulatory requirements and the results of the solvency assessment on a Solvency II basis, SWE will be capitalised to a level that the Transfer will not lead to a materially adverse impact on the security of the policyholders with benefits paid from the WPFs at the point of Transfer.
  - The Risk Capital Buffer that will be held by SWE along with the annual assessments of the company's financial condition (which will be subject to regulatory oversight) provides comfort that policyholder benefits should remain secure in the future.
- 5.64 I will continue to monitor the solvency position and risk profile of SWL and SWE and will, if necessary, provide an update in a Supplementary Report prior to the final Sanction Hearing court date.

## 6 IMPACT OF TRANSFER ON BENEFIT EXPECTATIONS

6.1 This section considers the impact of the Transfer on policyholder benefit expectations.

### **General Points**

6.2 With regard to the impact of the Transfer on benefit expectations, I note that the Scheme results in no material change to:

- Terms and conditions of either the Transferring Policies or the Non-Transferring Policies;
- Operation of the Funds, with-profits or unit-linked, available to Transferring Policies or Non-Transferring Policies; or
- Charges applied to either the funds or the policies; again for both the Transferring Policies and Non-Transferring Policies.

6.3 The SWL UL Fund investments will Transfer into matching UL Funds that have been set up in SWE and so the Transferring Policies with UL investments will continue to have their policy benefits linked to UL Funds with the same investments as was the case prior to Transfer. The new servicing agreement between SWE and Lloyds Bank plc will mean that box management and unit pricing of the UL Funds will continue to operate as currently.

6.4 Due to the reinsurance arrangement set out in Paragraphs 4.2 and 4.7 above, the Transferring Policies will continue to be invested in, and hence policy benefits linked to, the CM WPF as was the case prior to the Transfer.

6.5 This reinsurance arrangement will commence from the effective date of the Transfer and can only be altered (other than minor technical alterations) or terminated if:

- It is agreed by both parties; and
- A written report has been obtained from an independent actuary stating that policyholders are not materially adversely impacted; and
- There is no objection from the appropriate Regulators.

Alternatively SWE may terminate the reinsurance arrangement if SWL suffers an insolvency event and no objection to such termination is received from the CAA or PRA (where SWE would retain the withheld funds and an independent actuary would review the appropriateness of the termination amount).

6.6 This puts in place an appropriate framework for ensuring that the impact of any future alterations or termination of the reinsurance on policyholders, whether Transferring or Non-Transferring, considers the impact on the policyholders and allows an appropriate decision to be made at that time.

6.7 As a result of these general points, I do not expect that policyholders will be materially adversely affected by the Scheme. Further comments for each of the main categories of policy are provided below.

- 6.8 As a result I am satisfied there will be no materially adverse impact on the benefit expectations for the Transferring Policies.

***Transferring Policies with with-profits investments***

- 6.9 The Transferring with-profits policies will have their investment element, and the whole of the with-profits annuities (in payment at the Scheme Effective Date) liabilities, reinsured back to SWL's CM WPF. Although SWE is withholding the reinsurance premium the CM WPF will retain the economic interest in the withheld funds relating to the funds withheld from the CM WPF and will instruct SWE how to invest these assets so they are invested in the way the CM WPF requires them to be.
- 6.10 In addition, the amount of withheld funds will be reviewed and rebalanced on a quarterly basis. This rebalancing will ensure that SWL withholds an appropriate amount of assets to cover its reinsured liabilities.
- 6.11 The Transferring with-profits policies will be treated as if they had never left the CM WPF with regards to eligibility for bonus declarations including estate distribution.
- 6.12 The way in which the CM WPF is run will not change materially as a result of the Transfer (i.e. it will continue to be run in accordance with its PPFM and the LBGI 2015 Scheme). This means:
- There will be no change to the methodology used to calculate CM WPF with profits payouts as a result of the Scheme, including entitlement to estate distributions.
  - There will be no change to the investment policy of the CM WPF or to the expenses that are charged to the CM WPF as a result of the Scheme.
  - Tax will continue to be applied to the CM WPF as if it were a separate mutual company (as required by the LBGI 2015 Scheme) and will be unaffected by the change from benefits being directly insured to being reinsured.
  - There will be no changes to the PPFM of the CM WPF as a result of the Scheme, other than to reflect the Transfer itself.
  - The Scheme will not affect the merger and / or closure provisions regarding the CM WPF that are set out in the LBGI 2015 Scheme.
- 6.13 Although the SWE Board will be responsible for with-profits' bonus setting, determination of market value adjustments or similar matters (e.g. estate distribution, smoothing etc.) for the Transferring Policies with with-profits investments, as confirmed in the Scheme the SWE Board will resolve that the bonuses, market value adjustments and similar matters will follow the decisions made by SWL in respect of these policies in all reasonably foreseeable circumstances.
- 6.14 The initial with-profit annuity amount will be determined in line with the policy conditions stating that *"the initial annuity payment is determined according to*

*generally accepted actuarial principles and practices taking into account long-term assumptions regarding mortality experience and investment returns on relevant fixed-interest assets at the time”.*

- 6.15 As a result of the above, I am satisfied that the Transfer does not have a materially adverse impact on the benefit expectations of Transferring Policies with with-profits investments.

### ***Non-Transferring Policies***

- 6.16 As a result of the general points above and in addition taking into account that:

- the protections and safeguards of the LBG 2015 Scheme will remain in place and will be unaffected by the Scheme; and that
- the with-profit investment element and the with-profit annuities in payment of the Transferring Policies are reinsured back to the CM WPF and the CM WPF will continue to be managed in line with its PPFM; and that
- although SWE has withheld funds in respect of the reinsurance premium the CM WPF still gets the economic benefit of these funds (in the sense that it will be entitled to the risks and rewards arising from the income, gains and losses) and instructs SWE how to invest these assets so that they are invested in the same way as they would have been under SWL; and that
- there are no Transferring Policies in the SW WPF so the SW WPF will not be directly impacted by the Transfer; and that
- after allowing for the reinsurance arrangement, the Transfer is not material in the context of the WPFs or SWL as a whole;

I am satisfied that there will be no material change to the way in which the Non-Transferring SWL Policies with benefits paid from the WPFs are operated or treated and that, as a result, there will be no materially adverse impact on the benefit expectations of Non-Transferring SWL Policies with benefits paid from the WPFs.

### ***Overall Conclusions on Impact of Transfer on Benefit Expectations***

- 6.17 Taking into account the discussion in this section I am satisfied that the Scheme will not result in a materially adverse impact on the benefit expectations of policyholders with benefits paid from the WPFs.

## 7 OTHER CONSIDERATIONS

- 7.1 This section discusses the impact of the Transfer on policyholder taxation, administration, complaints escalation and governance. It also discusses the policyholder notification process.

### **Taxation**

- 7.2 Investigations into the tax impacts of the Transfer have revealed that the Transfer will not lead to a change in policyholder contractual terms/conditions and will not lead to changes in the underlying qualifying status of any policyholders.
- 7.3 As a result of SWE setting up an individual as Mandataire General, who is then recognised as a branch in Germany that branch will withhold the tax due to the German government on claim payments. For the Transferring policyholders that are domiciled in Germany this creates a timing difference in when tax payments are made but not to the amount of tax actually paid. As a result there is no material adverse impact to the policyholders.
- 7.4 The post Transfer set up of SWE means that the with-profits investment element and with profit annuities in payment of the Transferring Policies will be reinsured back to SWL and will be taxed in the same way as they currently are, including the allowance for taxation in unit pricing.
- 7.5 Luxembourg Value Added Tax will be charged on policy administration services provided to SWE. These costs will be met by the shareholders of SWE.
- 7.6 As a result there is no materially adverse impact on policyholder benefits or changes in taxation arrangements as a result of the Scheme.
- 7.7 Based on these findings I do not expect the Scheme to give rise to any materially adverse impact on policyholder benefits as a result of changes in taxation treatment.

### **Administration**

- 7.8 The administration of the Transferring Policies prior to the Transfer is outsourced by SWL to different service providers as indicated in the table below:

Policies	Serviced by
German & Austrian ILDE Policies	Heidelberger Leben Services Management GmbH
Italian ILDE policies	Information Technology Outsourcing S.R.L
Luxembourg (ex-CMIL) policies	Pack Assurance Management SA

- 7.9 Following the Transfer, the three arrangements above will transfer to SWE such that Transferring Policies will continue to be serviced via the same outsourcing

agreement as was the case prior to the Transfer. The administration of the Transferring Policies will therefore be unchanged by the Scheme.

7.10 As a result of these points, I would not expect the Scheme to lead to a materially adverse impact on policy servicing for the Transferring Policies.

7.11 In respect of the Non-Transferring Policies, the existing administration is not changed by the Scheme. As a result, I would not expect the Scheme to lead to a materially adverse impact on policy servicing for Non-Transferring policyholders.

### ***Complaints Escalation Process***

7.12 In the UK, there is an independent Financial Ombudsman Service (FOS) for dealing with policyholder complaints where the policyholder is not satisfied with how the insurance company resolved the complaint. The FOS has the authority, and powers, to make decisions on these complaints that are binding for the insurance companies.

7.13 Luxembourg does not have a FOS but has several Alternative Dispute Resolution Bodies ("ADRB"), these are:

- The CAA whose decisions are not legally binding but can be presented as evidence if the complaint is escalated to the Court;
- The Mediateur en assurance ("MEA") set up jointly by the Association of Insurers and Reinsurers ("ACA") and the Luxembourg Union of Customers ("ULC"). This service provides mediation proceedings between the relevant parties and its decision is not legally binding unless the insurer and complainant involved in the dispute have entered into a mediation agreement making the decision legally binding. The MEA is a voluntary service for the insurance companies to choose to participate in; and
- The National Consumer Ombudsman Service ("NCOS"), which handles disputes relating to sales or servicing. This service provides mediation proceedings between the relevant parties and its decision is not legally binding unless the insurer and complainant involved in the dispute have entered into a mediation agreement making the decision legally binding. It is a voluntary service for the insurance companies to choose to participate in.

7.14 The IFS Policies that are currently serviced by SWL's Luxembourg branch don't have access to the UK FOS pre Transfer but instead have access to the Luxembourg ADRBs.

7.15 Currently, rather than raising a complaint with the UK FOS, or Luxembourg ADRBs, for the IFS Policies currently serviced by SWL's Luxembourg branch (other than the CAA as a Regulator), as they are entitled to, policyholders with IFS policies raise their complaint with the Regulator of the EU27 country in which their policy was written in or where they are domiciled, e.g. Germany, Italy etc. This EU27 Regulator would then work with SWL so that SWL resolves the complaint appropriately.



- 7.16 If the policyholder is not satisfied with the resolution they retain the right to take their complaint to the court in the country which their policy was written or where they are domiciled.
- 7.17 Post Transfer, the Transferring policyholders will not be likely to use any of the Luxembourg ADRBs (other than the CAA as the Regulator) but rather would be expected to continue to raise complaints with the same Regulator as they currently would. That Regulator will then work with SWE to ensure that SWE resolves the complaint appropriately.
- 7.18 As pre Transfer, if the policyholder is not satisfied with the resolution, they retain the right to take their complaint to the court in the country in which their policy was written or where they are domiciled.
- 7.19 In addition, post Transfer the Transferring Policies that currently have access to the FOS can still take a complaint about activities that took place before the Scheme Effective Date to the FOS.
- 7.20 The Non-Transferring Policyholders will continue to be able to raise any unresolved complaints in the same way as they currently do.
- 7.21 In summary, I am satisfied that the Transfer will have no materially adverse impact on the complaints escalation process for either Transferring or Non-Transferring Policyholders.

### **Governance**

- 7.22 Following the Scheme coming into effect, the LBGI Board, supported by the WPA and With-Profits Committee ("WPC"), will continue to provide governance over the with-profits benefits of the Transferring Policies and the way in which the CM WPF is run will not change materially as a result of the Transfer (i.e. it will continue to be run in accordance with its PPFM and the LBGI 2015 Scheme).
- 7.23 The SWE Board will be responsible for with-profits' bonus setting, determination of market value adjustments or similar matters (e.g. estate distribution, smoothing etc.) for the Transferring Policies with with-profits investments. As confirmed in the Scheme, the SWE Board will resolve that the bonuses, market value reductions and similar matters will follow the decisions made by SWL in respect of these policies in all reasonably foreseeable circumstances.
- 7.24 Overall, I am satisfied that the Scheme will not result in a materially adverse impact on the way that the Transferring Policies and the remaining policies are managed or governed.

### **Cancellation Rights**

- 7.25 Austrian and Italian regulations respectively give the transferring Austrian and Italian policyholders the option to surrender their policies as a result of the Transfer. For some of these policies such a surrender might be free of any surrender charges. The costs of foregoing such charges are expected to be met by the SWL

shareholders. At the appropriate time, to be agreed with the regulators, SWE (or SWL if prior to the Transfer) will write to the affected policyholders informing them of their cancellation rights, explaining what this means for them, how long they have these cancellation rights and how to go about exercising their cancellation rights.

- 7.26 This would not be expected to have a materially adverse impact on the policyholders, whether Non-Transferring or Transferring, and the CM WPF but I will continue to monitor this and comment in a supplementary report if this expectation changes.

### ***Notification to policyholders***

- 7.27 LBGi will be writing to all of the Transferring Policies in order to inform them of the proposed Scheme. LBGi will be seeking waivers in respect of the following:

- The holders of the Non-Transferring Policies of the Transferor; and
- Policyholders for whom no current address is held on record (Goneaways).

- 7.28 The application for a waiver for the holders of the Non-Transferring Policies is driven by the immaterial impact of the changes on these policyholders from the Scheme and the belief that were SWL to write out to them, along with all the accompanying documentation, the changes would appear to be more significant and would give rise to some confusion.

- 7.29 A detailed communication plan has been produced to ensure the holders of the Transferring Policies are adequately informed of the nature and effect of the Scheme in their native language. The communications package includes direct mailing, press adverts and web content. The intention is that the mailed package would meet the legal and regulatory requirements and provide an appropriate level of detail enabling the policyholders to understand the Transfer.

- 7.30 The policyholders will be directed to specific website content where further technical information can be obtained or a contact for requesting additional printed material, all free of charge.

- 7.31 Overall, I am satisfied that the proposed communication plan is appropriate and has paid due regard to the interests of policyholders and the need to treat them fairly, as well as their information needs. In particular, given the conclusions contained in this report and the general immateriality of the Transfer on the wider business of SWL, I am satisfied that the Non-Transferring policyholders do not need to be contacted directly.

## 8 CONCLUSION

- 8.1 I have produced this report in my role as WPA for SWL, to set out the impacts of the Transfer on the policyholders with benefits paid from the WPFs.
- 8.2 In assessing the potential impacts of this Scheme, I have given due consideration to the effects of the planned Transfer on the security, administration and benefit expectations of the policyholders with benefits paid from the WPFs.
- 8.3 Taking into account the key features of the Transfer outlined earlier (and the discussion of these and other matters contained in this report), it is my view that:
- Taking into account the assets and liabilities being transferred to the Transferee, the reinsurance agreement, withheld funds, indemnity and the Capital Policies of SWL and SWE, the security of the policyholders with benefits paid from the WPFs will not be materially adversely impacted as a result of the Scheme;
  - The Scheme will not result in materially adverse changes to the benefit expectations of any policyholders with benefits paid from the WPFs.
- 8.4 I therefore conclude that the Scheme will not result in a materially adverse impact on the security of policyholders or their benefit expectations compared to the status quo.
- 8.5 I am satisfied that there will be no significant impact on the servicing that policyholders will receive as a result of the Scheme and that the proposed communications plan is appropriate and has paid due regard to the interests of policyholders and the need to treat them fairly.



Alasdair Smith FFA

With-Profits Actuary for SWL

16 November 2018

## 9 ANNEX A – DEFINED TERMS AND ABBREVIATIONS USED WITHIN THIS REPORT

ACA	Association of Insurers and Reinsurers, who have set up the MEA with the ULC.
ADRB	Alternative Dispute Resolution Bodies, a term used to reference the various entities in Luxembourg who help to resolve disputes between customers and insurers.
APS	Actuarial Professional Standards
Available Capital	The difference between the value of a company's assets and the value of its liabilities
Best Estimate Liabilities	The best estimate value of liabilities as defined under Solvency II regulations.
CAA	Commissariat aux Assurances(translation: Insurance Commissioner) - The Luxembourg regulator for SWE.
CM WPF	SWL's Clerical Medical With-Profits Fund
CMIG	Clerical Medical Investment Group Ltd
CMIL	CMI Insurance (Luxembourg) S.A.
Capital Policy	This is the internal approach to capital management followed by SWE or SWL.
Combined Fund	Under Solvency II this is all the assets of a company excluding any ring-fenced with-profits funds
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
EU	European Union
EU27	European Union excluding the UK
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Services
FSCS	Financial Services Compensation Scheme
IE	Independent Expert
ILDE	International Life Division Europe
LBG	Lloyds Banking Group plc
LBGI	LBG Insurance
LBGI 2015 Scheme	Legal scheme implemented on 31 December 2015 under which several of the subsidiaries of Scottish Widows Group Limited were transferred to SWL
MEA	Mediateur en assurance, a ADRB in Luxembourg set up jointly by the ACA and ULC
NCOS	National Consumer Ombudsman Service, a Luxembourg ADRB
Non-Transferring Policies	SWL policies which are out of scope of the Scheme

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PPFM	Principles and Practices of Financial Management
PRA	Prudential Regulation Authority
Regulatory Capital Requirements	The capital to be held over and above the Solvency II Best Estimate Liabilities and Risk Margin that an insurer is required to hold under Solvency II regulations
Risk Capital Buffer	Additional capital held in accordance with the relevant capital and risk appetite policy.
Risk Margin	This is the additional capital that insurers have to hold under Solvency II regulations, based on the value of the projection of the non-hedgeable risks of the Regulatory Capital Requirement.
Scheme	An insurance business transfer scheme under Part VII of the Financial Services and Markets Act 2000 ("FSMA")
Scheme Effective Date	The date that the Scheme will come into existence, 28 March 2019
Shareholder's Regulatory Capital Requirements	The Regulatory Capital Requirements for the SWL Combined Fund allowing for any support provided to With Profit Funds by the Combined Fund.
SWE	Scottish Widows Europe, the Transferee
SWG	Scottish Widows Group Limited
SWL	Scottish Widows Limited
SW WPF	Scottish Widows With Profit Fund
Transfer	Proposed transfer of the Transferring Policies from SWL to SWE
Transferee	Entity receiving business (SWE under the Scheme)
Transferor	Entity transferring business (SWL under the Scheme)
Transferring Policies	Inforce business originally sold by either ILDE or CMILL. These are the policies which will be transferred from SWL to SWE under this Scheme.
UK	United Kingdom
ULC	Luxembourg Union of Customers, who set up the MEA in Luxembourg with the ACA.
Working Capital	The excess of the Available Capital over Regulatory Capital Requirement
Working Capital Ratio	The Available Capital divided by the Regulatory Capital Requirement expressed as a percentage.
WPA	With-Profits Actuary
WPC	With-Profits Committee
WPF	With-Profits Fund

