With-Profits Actuary Report

on

the proposed transfer of a portfolio of non-profit annuity policies and related longevity swap contracts

of

The Prudential Assurance Company Limited

to

Rothesay Life Plc

pursuant to Part VII of the Financial Services and Markets Act 2000

1. Introduction

1.1. Background

1.1.1. On 14 March 2018 The Prudential Assurance Company Limited ("PAC") entered into a commercial agreement with Rothesay Life Plc ("RL") regarding the sale from PAC to RL of a portfolio of approximately 400,000 non-profit annuity policies ("the Sale Portfolio") and related longevity swap contracts. At this time materially all of the economic risk and reward of the Sale Portfolio was transferred from PAC to RL through a reinsurance agreement ("the Reinsurance Agreement"). The proposed transfer is the final step in the process to remove PAC as the insurer in relation to the business moving as a result of the proposed transfer ("the Transferring Business"), which comprises substantially the whole of the Sale Portfolio as described in sections 3.4 and 3.5.

1.1.2. The proposed transfer will take effect by means of an insurance business transfer scheme ("the Scheme") under Part VII of the Financial Services and Markets Act 2000 ("FSMA").

1.1.3. This report, on the proposed transfer of a portfolio of PAC's non-profit annuity policies to RL, has been prepared in my capacity as With-Profits Actuary of PAC, and sets out my opinion of the impact of the Scheme on the security and reasonable benefit expectations of the with-profits policyholders remaining in PAC following the transfer.

1.2. Other advice and opinions

1.2.1. The PAC Chief Actuary has produced a report which considers the impact of the Scheme from the perspective of the PAC policyholders (both transferring and non-transferring), while the Chief Actuary of RL has produced a report which considers the Scheme from the perspective of RL's existing policyholders. In addition Nick Dumbreck of Milliman has been retained by PAC and RL, and approved by the PRA, after consultation with the FCA, to produce a report on the terms of the Scheme in the capacity of Independent Expert. I have considered these reports and provided a copy of this report to the PAC Chief Actuary, the Chief Actuary of RL and Mr Dumbreck.

1.2.2. This report should be read in conjunction with the Scheme as well as the reports of the PAC Chief Actuary, the Chief Actuary of RL and the Independent Expert.

1.3. Disclosures

1.3.1. I am a Fellow of the Institute and Faculty of Actuaries, having qualified as such in 1982, and hold a certificate issued by the Institute and Faculty of Actuaries to act as a Life Actuary (including with-profits). I am an employee of Willis Towers Watson and I have been the PAC With-Profits Actuary since February 2015.

1.4. Structure of report

1.4.1. This report is structured as follows:
- Section 2 provides information on the current operations of PAC and RL;
- Section 3 sets out relevant details of the Scheme;
- Section 4 considers the effect of the Scheme on the PAC with-profits policyholders;
- Section 5 sets out my conclusions.

1.5. Compliance with Technical Actuarial Standards

1.5.1. This report is subject to, and complies with, all relevant Technical Actuarial Standards ("TASs") adopted by the Financial Reporting Council in the UK, in particular it complies with TAS 100: Principles for Technical Actuarial Work.

1.5.2. In accordance with Actuarial Profession Standards ("APS") issued by the Institute and Faculty of Actuaries, "APS X2: Review of Actuarial work" requires Members of the profession to consider an appropriate level of review for the actuarial work for which they are responsible. This report has been reviewed internally within PAC and has also been subject to peer review by Trevor Fannin of Willis Towers Watson.

1.6. Intended Users

1.6.1. The intended users of this report are the Court, Board of Directors of PAC, the Independent Expert, the PRA and FCA, the PAC With-Profits Committee and the PAC Chief Actuary.

1.6.2. This report will also be available to policyholders of PAC and RL and to other interested parties.

2. Company Information

2.1. The Prudential Assurance Company Limited

2.1.1. PAC is a proprietary company whose ultimate parent company is Prudential Plc and whose principal activity is long-term insurance business which includes conventional with-profits, accumulating with-profits, non-linked non-profit and linked business.

2.1.2. PAC has a Shareholder Fund and also maintains a long term insurance fund, in which it writes its long-term insurance business. The long term insurance fund is made up of the Non-Profit Sub-Fund ("NPSF") and the With-Profits Fund with the latter comprising three ring-fenced funds: the With-Profits Sub-fund ("WPSF"), the Defined Charge Participating Sub-Fund ("DCPSF") and the Scottish Amicable Insurance Fund ("SAIF").

2.1.3. The with-profits business written in the WPSF shares in the fund's divisible profit, with their proportion being at least 90% and the balance being attributable to shareholders whilst the whole of the profit arising in SAIF will be allocated to with-profits policyholders. For the business written in the DCPSF, the policyholder receives 100% of investment related profits whilst the shareholder receives the profits or losses arising from any difference between the charges and expenses.

2.1.4. At 30 June 2018 PAC and its subsidiaries had an estimated Solvency II shareholder surplus of £7.7bn and with-profits surplus on an economic basis (allowing for the liability related to the present value of future shareholder transfers) of £6.1bn[1], equivalent to solvency coverage ratios of 207% and 258% respectively. The consolidated PAC solvency ratio was 162%. The total shareholder Solvency II best estimate liabilities ("SII BEL") were £56.3bn whilst the total With-Profits Fund SII BEL was £116.6bn. These figures do not allow for the impact of the transfer of the legal ownership of PAC's Hong Kong subsidiaries to Prudential Corporation Asia Limited ("PCA") which occurred in December 2018.

2.1.5. The Transferring Business is all shareholder backed non-profit annuity business within the PAC NPSF, including some non-profit annuities reinsured from the WPSF.

2.1.6. At 30 June 2018 the PAC NPSF had a SII BEL of £45.0bn, of which approximately £32.0bn is in respect of non-profit annuity business. The Transferring Business comprises approximately 36% of the non-profit annuity business within the PAC NPSF and around 27% of PAC's total non-profit annuity business. The WPSF also contains a significant volume of with-profits annuity policies. Following the proposed transfer it is expected the volume of annuity business remaining in the NPSF will be broadly similar to the annuity business in the WPSF.

2.1.7. In August 2017, Prudential Plc announced that it was combining two businesses within the Prudential group, Prudential UK & Europe, as part of which PAC operates as the main insurance company in the UK and Europe, and its asset manager, M&G, to form a combined business called M&G Prudential. In March 2018, it was also announced that M&G Prudential would demerge from the Prudential group, resulting in two separately listed companies. I do not expect this merger and demerger to change the conclusions in this report.

2.1.8. Prudential Plc also announced that it intended to transfer the legal ownership of its Hong Kong insurance subsidiaries from PAC to PCA, another subsidiary of Prudential Plc to align the ownership of Prudential group's business with their operating structures. This was completed in December 2018 and does not change the conclusions in this report.

2.1.9. As at 1 January 2019 Prudential consolidated all of its long-term business written in Europe (excluding the UK) into one entity, Prudential International Assurance ("PIA"), which is a subsidiary of PAC authorised and domiciled in Ireland. This streamlines Prudential's operating model and enables simpler management structures, especially when the UK leaves the European Union in March 2019. This does not change the conclusions in this report.

2.1.10. PAC is currently undertaking activity relating to the transfer, under Part VII of the FSMA of certain protection business to Vitality Life Limited. I do not expect this to change the conclusions in this report.

[1] On regulatory basis, which does not allow for the liability related to the present value of future shareholder transfers, the with-profits surplus is £8.9bn, equivalent to a solvency coverage ratio of 332%.

2.1.11. PAC is currently completing a transformation program, one of the aims of which is to decrease PAC's overall cost base. As part of this program PAC, in January 2018, entered into a strategic partnership with Tata Consultancy Services ("TCS") and Diligenta, its UK subsidiary. This partnership will result in TCS and Diligenta providing the administration services for over four million of Prudential's life and pensions policies.

2.2. Rothesay Life Plc

2.2.1. RL is a public limited company, the shares of which are 100% owned by Rothesay HoldCo UK Limited. RL was authorised by the Financial Services Authority as a regulated insurance company in 2007.

2.2.2. RL is a wholesale annuity provider established to provide solutions in the UK defined benefit pension risk transfer market. They source their business through bulk annuity business from pension schemes, reinsurance of annuity portfolios followed by Part VII transfers and through acquisition of other annuity providers. RL has previously completed successful transfers of annuity business from Zurich Assurance Ltd and Scottish Equitable Plc.

2.2.3. The RL Group follows a strategy which aims to protect regulatory surplus by minimising balance sheet volatility and achieving attractive risk-adjusted returns through de-risking the business by hedging longevity risk and adopting a cautious approach to investment.

3. Proposed Scheme

3.1. The Proposed Transfer

3.1.1. Under the proposed Scheme, substantially the whole of the Sale Portfolio of non-profit annuity business and related longevity swap contracts of PAC will be transferred to RL. The proposed transfer will take effect by means of an insurance business transfer scheme under Part VII of the FSMA.

3.1.2. In transferring the business described in sections 3.4 and 3.5, from PAC to RL, the liabilities attributable to the Transferring Business (other than excluded liabilities) will be allocated to RL.

3.1.3. Following the execution of the Reinsurance Agreement on 14 March 2018, the premium was paid by asset transfer from PAC to RL. Although adjustments to this premium may be necessary due to events such as the data audit, no financial assets will be transferred as a result of the Part VII Transfer.

3.1.4. The collateral arrangement over assets of RL currently held in custody accounts, established by the Reinsurance Agreement and certain other legal agreements will, in respect of the Transferring Business, fall away on the Scheme Effective Date. As described in 3.4.7, Non-Transferring Policies will continue to be reinsured under an amended version of the reinsurance agreement between PAC and RL, together with appropriate collateralisation arrangements agreed between PAC and RL.

3.2. Effective Date of Transfer

3.2.1. It is intended that the Transferring Policies and related longevity swap contracts will transfer from PAC to RL on 26 June 2019, or such other time and date as may be agreed by PAC and RL and approved by the Court.

3.3. Administration

3.3.1. From 1 October 2018 PAC's strategic partnership with TCS and Diligenta was extended to include PAC's annuity business and so from that date PAC has outsourced its policy administration for the Sale Portfolio to TCS and Diligenta. Before 1 October 2018 the Transferring Business was administered by PAC and other Group companies using in-house systems.

3.3.2. It has been agreed by RL and PAC that, from the effective date of the transfer there will be a Transitional Services Agreement ("TSA") such that PAC will continue to carry out the administration services for the transferring policyholders, under RL's responsibility. The TSA is expected to be in place for a period of 12 to 24 months, after which RL will transfer the administration away from PAC, although it may remain with TCS and Diligenta through a direct relationship with RL.

3.4. Transferring Business

3.4.1. The non-profit annuity liabilities in the PAC NPSF include:

- Annuities originally written by Scottish Amicable Life Plc that were subsequently transferred to PAC on 31 December 2002;
- Annuities written directly in the PAC NPSF; and
- Annuities originally written in Prudential Retirement Income Limited that were subsequently transferred to PAC on 1 October 2016.

3.4.2. The Sale Portfolio comprises approximately 400,000 annuity policies. These are all shareholder backed non-profit annuities either written directly in the PAC NPSF or reinsured into the NPSF, from the WPSF. The Sale Portfolio also covers a mix of types of business, including retail and bulk business, business with and without longevity reinsurance and business with and without exposure to the FCA's Thematic Review of Annuities Sales Practices.

3.4.3. Since the original identification of the Sale Portfolio, a number of modifications have been made to ensure that the Sale Portfolio meets the commercial requirements agreed between PAC and RL on 14 March 2018 and constitutes a portfolio that can be transferred by means of the Part VII transfer.

3.4.4. Modifications have been made to reallocate to the PAC NPSF c£0.75m per annum of benefits in respect of c200 non-profit annuities which were originally allocated to the PAC WPSF. This was to ensure policy integrity, whereby all benefits associated with a policy must be included in the Transferring Business. I reviewed the terms of this reallocation to ensure they were fair and reasonable.

3.4.5. The Transferring Business will be the policies that are reinsured under the Reinsurance Agreement immediately prior to the effective date of the transfer, other than Excluded Policies, which the original agreement between PAC and RL included provision for, and the Non-Transferring Policies noted in section 3.4.7.

3.4.6. Excluded Policies are policies which are reinsured under the Reinsurance Agreement but which are not capable of being transferred at the Transfer Date. Excluded Policies will continue to be reinsured under an amended version of the reinsurance agreement between PAC and RL. Currently, there are not expected to be any excluded policies.

3.4.7. Non-Transferring Policies are policies that were initially included in the Transferring Business but which PAC and RL have agreed should not be transferred under the Scheme. The volume of Non-Transferring Policies is expected to be c.10% (measured by gross liability value) of the total business reinsured under the Reinsurance Agreement. Non-Transferring Policies will continue to be reinsured under an amended version of the reinsurance agreement between PAC and RL, together with appropriate collateralisation arrangements agreed between PAC and RL.

3.5. Longevity Swaps

3.5.1. Some of the liabilities within the Transferring Business are subject to existing longevity swaps that PAC has entered into with a number of reinsurers. These longevity swaps are included within the Transferring Business and will transfer from PAC to RL as part of the Part VII Transfer, subject to any changes in terms that RL may agree with the relevant reinsurers. Where required, consent to the Part VII Transfer has either been received from reinsurers, or is currently being discussed between parties and the reinsurers.

3.6. Costs of the Scheme

3.6.1. Policyholders will not bear any of the costs associated with the Part VII Transfer.

4. Effect of Scheme on PAC With-Profits Policyholders

4.1. Direct Impacts of Part VII Transfer

4.1.1. There is no direct impact on the With-Profit Fund of the Part VII Transfer as no PAC with-profits policyholders are included within the Transferring Business. The Transferring Business is all non-profit annuity business from the NPSF.

4.2. Indirect Factors Potentially Affecting PAC Policyholders or the WPSF Estate

4.2.1. The interests of the remaining PAC with-profits policyholders in the WPSF, SAIF and DCPSF, or the WPSF estate could be affected by the Scheme, through

- changes in their security due to changes in the solvency of the shareholder fund
- the potential impact on the allocation of costs, and in particular overheads, to the WPSF
- the potential impact of costs associated with the strategic partnership with TCS and Diligenta.

4.3. Security of Policyholders' Benefits

4.3.1. The Part VII Transfer is expected to increase the solvency of the shareholder balance sheet by c. £155m. As a result no adverse impact is expected on the capital held within the shareholder fund to support the With-Profits Fund. I thus consider that there will be no adverse impact in the security of the remaining PAC policyholders' benefits.

4.4. Potential Impact on the allocation of costs to the WPSF

4.4.1. The cost allocation process allocates costs incurred by the business between acquisition and renewal costs and allocates renewal costs to the underlying inforce policies. Although some of the costs incurred vary in relation to the volume of business inforce, many of these costs are fixed in the short term and are shared either across all policies or across a subset of policies.

4.4.2. A proportion of these fixed costs, which consist of both annuity administration expenses and overheads are currently allocated to the Transferring Business and so when the administration of these policies is transferred away from PAC the fixed costs will be re-spread. The fixed annuity administration expenses will be re-spread across the reduced number of annuity policies, which are broadly equally split between PAC WPSF and PAC NPSF, while the overheads will be re-spread across all the remaining business, including the remaining annuity policies.

4.4.3. The projected total renewal expenses allocated to non-profit annuities in PAC NPSF are approximately £24m, of which c.70% are estimated to be fixed in the short term. Thus, once PAC ceases to provide administration services to RL in respect of the transferred business, which represent c. 32% of the non-profit annuities in the PAC NPSF, a significant volume of fixed costs will be re-spread, of which c.£3m per annum will fall on the annuity business in PAC WPSF. These policies incur a fixed charge to cover expenses and thus it is the estate of the With-Profit Fund that incurs the profits or losses arising from differences between these charges and the actual expenses.

4.4.4. Given the potential impact of additional annuity costs falling on the With-Profit Fund estate in the short term and to allow the business to 'right size' its fixed costs the Shareholder has agreed to cover £7m of these additional costs. Provided that a reduction in the annuity costs can be achieved over a three to four year period it would mean there should be no material impact on the With-Profit Fund estate. I would also note that the amounts involved are not material in the context of the size of the With-Profit Fund estate.

4.4.5. The Transferring Business represents c.6% of PAC's total liabilities and hence, all else being equal this would be expected, once PAC ceases to provide administration services to RL, to increase overheads allocated to the remaining policies by just over 6%. However, as set out in section 2.1.11, PAC is currently also undertaking a Transformation Program which aims to decrease the cost base of the company, with a significant focus being to reduce the overheads of the business. This should lead to a reduction in the costs allocated to all with-profit policies.

4.4.6. The savings from the Transformation project are expected to more than offset the impact of re-spreading the overheads previously allocated to the Transferring Policies. As a result I believe there will be no material adverse impact on policyholders from the re-spreading of overheads over the reduced number of policies which will remain following the Part VII Transfer.

4.5. Potential Impact on costs of Strategic Partnerships

4.5.1. The strategic partnership which PAC has entered into with TCS and Diligenta includes clauses requiring compensation to be paid by PAC if PAC makes changes to its business which results in business covered by the agreement being transferred away from TCS and Diligenta.

4.5.2. Initial work has indicated that the volume of annuity business included within the Sale Portfolio is insufficient to trigger the compensation clauses when PAC ceases to provide administration services to RL, through TCS and Diligenta. However, as these clauses apply cumulatively, any subsequent transfer or transfers of with-profits business covered by the TCS and Diligenta agreement are more likely to result in a trigger at that time.

4.5.3. Once the compensation clause has been triggered a one-off payment would be payable by PAC, with the amount depending on the income lost as a result of the transfer and when the transfer occurs. Thus a payment will arise in respect of each transfer which has contributed to it being triggered with that payment being appropriately allocated between the funds within PAC. This approach means that each fund will be allocated the full amount of the compensation payment that is attributable to it, irrespective of when the penalty clause is actually triggered. I am comfortable this will ensure the With-Profits Fund will not incur any material additional costs in relation to penalties applying from the TCS and Diligenta agreement.

4.6. Other Considerations

4.6.1. I have been advised that the proposed transfer is not expected to have a material impact on the tax position of PAC and thus the Scheme is not expected to have any effect on policyholder taxation.

4.6.2. The proposed transfer is not expected to result in any changes to the PAC With-Profits Fund Principles and Practices of Financial Management. Thus there will no change as a result of the transfer in the way that the With-Profits Fund is managed and no impact on the reasonable benefit expectations of existing policyholders.

4.6.3. PAC is not proposing to write to its non-transferring policyholders as it would be disproportionate to do so given the cost of such an exercise and the impact of the transfer on these policyholders. On this basis a waiver is being requested from the PRA and FCA. I consider this approach to be appropriate.

5. Conclusion

5.1. In my opinion the proposed scheme will not result in any material adverse effect on either the security or the reasonable benefit expectations of the with-profits policyholders of PAC.

Peter Needleman FIA
Willis Towers Watson
PAC With-Profits Actuary
18 January 2019