



# Co-operative Banking Group

**Report of the Independent Expert on the  
proposed transfer of the general insurance  
and reinsurance business of Royal London  
(CIS) Limited to CIS General Insurance Limited**

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## TABLE OF CONTENTS

<b>1. PURPOSE AND SCOPE</b>	<b>3</b>
<b>2. REGULATORY BACKGROUND</b>	<b>9</b>
<b>3. BACKGROUND ON THE ENTITIES CONCERNED IN THE SCHEMES</b>	<b>14</b>
<b>4. THE PROPOSED SCHEMES</b>	<b>26</b>
<b>5. GENERAL CONSIDERATIONS OF THE INDEPENDENT EXPERT AND THE INDEPENDENT ACTUARY</b>	<b>32</b>
<b>6. THE IMPACT OF THE SCHEMES ON THE TRANSFERRING POLICYHOLDERS OF RLCIS</b>	<b>34</b>
<b>7. THE IMPACT OF THE SCHEMES ON THE POLICYHOLDERS OF RLCIS WHO WILL REMAIN IN PLACE AFTER THE TRANSFER</b>	<b>47</b>
<b>8. THE IMPACT OF THE SCHEMES ON THE CURRENT CISGIL POLICYHOLDERS</b>	<b>49</b>
<b>9. OTHER CONSIDERATIONS</b>	<b>51</b>
<b>10. CONCLUSIONS</b>	<b>56</b>
<b>APPENDIX A DEFINITIONS</b>	<b>57</b>
<b>APPENDIX B TERMS OF REFERENCE</b>	<b>58</b>
<b>APPENDIX C CV FOR DEREK NEWTON</b>	<b>60</b>
<b>APPENDIX D KEY SOURCES OF DATA</b>	<b>61</b>
<b>APPENDIX E PICTORIAL SUMMARY OF THE SCHEMES</b>	<b>64</b>
<b>APPENDIX F SUMMARY OF DOCUMENTATION EXECUTED IN JANUARY 2006</b>	<b>66</b>
<b>APPENDIX G MINIMUM CAPITAL REQUIREMENT FOR GENERAL INSURANCE BUSINESS AS AT THE 2012 YEAR-END</b>	<b>67</b>
<b>APPENDIX H OUTWARDS REINSURANCE PROGRAMMES FOR RLCIS</b>	<b>68</b>
<b>APPENDIX I OUTWARDS REINSURANCE PROGRAMMES FOR CISGIL</b>	<b>69</b>

## 1. PURPOSE AND SCOPE

### PURPOSE OF REPORT

- 1.1 It is proposed that all of the general insurance and reinsurance business of Royal London (CIS) Limited (“RLCIS”), formerly known as Co-operative Insurance Society Limited) be transferred to CIS General Insurance Limited (“CISGIL”) by an insurance business transfer scheme (“the Scheme”) as defined in Section 105 of the Financial Services and Markets Act 2000 (“FSMA”). It is also proposed that general insurance and reinsurance business written by RLCIS in circumstances that required RLCIS to be authorised under Jersey law (“RLCIS’s Jersey Business”) be transferred to CISGIL by an insurance business transfer scheme (the “Jersey Scheme”) pursuant to Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996.
- 1.2 A list of terms defined in this report (“the Report”) is shown in Appendix A. Otherwise I use the same defined terms as are in the Scheme or the Jersey Scheme as appropriate. Unless otherwise specified, references in the Report to the insurance business / policyholders of RLCIS and CISGIL are in respect of all general insurance and reinsurance business / policyholders of RLCIS and CISGIL including the Jersey business of RLCIS and CISGIL.
- 1.3 Section 109 of FSMA requires that an application to the High Court of Justice in England and Wales (“the Court”) for an order sanctioning an insurance business transfer scheme must be accompanied by a report on the terms of the scheme (“the FSMA Report”) by an independent person (“the Independent Expert”) having the skills necessary to make the report and who is nominated or approved by the Prudential Regulatory Authority (“PRA”) and the Financial Conduct Authority (“FCA”), or by their predecessor body, the Financial Services Authority (“FSA”). The FSMA Report is required in order that the Court may properly assess the impact of the proposed transfer, including the effect on the policyholders of the insurance companies in question. Similarly, paragraph 3 of Schedule 2 of the Insurance Business (Jersey) Law 1996 requires that an application to the Royal Court of Jersey (“the Jersey Court”) for an order sanctioning an insurance business transfer scheme must be accompanied by a report on the terms of the Jersey Scheme (“the Jersey Report”) by an independent actuary (“the Independent Actuary”).
- 1.4 RLCIS and CISGIL have nominated me to act as Independent Expert to provide the FSMA Report in respect of the Scheme, and the FSA and subsequently the PRA have approved my appointment (see paragraph 1.12 below). RLCIS and CSGIL have also requested me to act as the Independent Actuary to provide the Jersey Report in respect of the Jersey Scheme.
- 1.5 The Report describes the proposed transfers and discusses their possible effects on the policyholders of CISGIL and RLCIS (in respect of all business of CISGIL and RLCIS and in respect of the Jersey business of CISGIL and RLCIS), including effects on security and levels of service. As such, the Report fulfils the requirements of both the FSMA Report and the Jersey Report.

### THE PROPOSED SCHEME AND JERSEY SCHEME

- 1.6 Under the Scheme, all of the general insurance and reinsurance business written by RLCIS is to be transferred into CISGIL. Similarly, under the Jersey Scheme, all of RLCIS’s Jersey Business is to be transferred into CISGIL. RLCIS ceased writing new, and renewing existing, general insurance and reinsurance business in January 2006; thereafter its existing business was renewed into CISGIL.
- 1.7 In accordance with an agreement between RLCIS and CISGIL dated 15 January 2006 (“the Indemnity Agreement”) and subsequently amended and restated by deed dated 31 July 2013 (“the Deed of Amendment and Restatement”), CISGIL has indemnified RLCIS for all payments, net of reinsurance recoveries, arising under RLCIS’s general insurance and reinsurance business. Under the same agreement, RLCIS has agreed to pay to CISGIL all non-reinsurance recoveries. The run-off of RLCIS’s general insurance and reinsurance business is currently handled by CISGIL.
- 1.8 The Co-operative Group is the UK’s largest mutual business. Among its many interests are financial services which are managed under Co-operative Banking Group Limited (“CBGL” and formerly known as Co-operative Financial Services Limited), a holding company. CBGL has several subsidiaries, covering insurance and banking, which I refer to collectively within the Report as Co-operative Banking Group (“CBG”). At the time that I wrote the Report:

- CISGIL was a subsidiary of CBGL and therefore part of CBG; and
  - RLCIS was a subsidiary of the Royal London Mutual Insurance Society Limited (“Royal London”). Prior to its purchase by Royal London, RLCIS, formerly Co-operative Insurance Society Limited, was a subsidiary of CBGL and therefore part of CBG. The sale and purchase of RLCIS was completed on 31 July 2013.
- 1.9 The Effective Date of both the Scheme and the Jersey Scheme (collectively “the Schemes”) is expected to be 31 March 2014. The Scheme is intended to have the effect that all the liabilities under the policies comprising the transferred business, and appropriate assets of the same value, will pass under the Scheme to CISGIL. The Jersey Scheme is intended to have the effect that all the liabilities relating to RLCIS’s Jersey Business, and appropriate assets of the same value, will pass to CISGIL.
- 1.10 I note that in March 2013 CBG announced that it intended to sell CISGIL in its entirety. As at the time of writing the Report there has been no further public announcement regarding progress with the sale of CISGIL.
- 1.11 The business involved in the Scheme, the arrangements for the Scheme and the effect of the Scheme are discussed in more detail in Sections 3 to 9 of the Report. The Jersey Scheme mirrors the Scheme, save that it relates to the transfer of just RLCIS’s Jersey Business rather than to all of the general insurance and reinsurance business written by RLCIS, and is conditional on the Scheme being effective. Therefore, in Sections 3 to 9 of the Report I have not repeated the discussion of the business involved in the Jersey Scheme, the arrangements for the Jersey Scheme and the effect of the Jersey Scheme, but have noted separately my conclusions relating to the Jersey Scheme.

## THE INDEPENDENT EXPERT

- 1.12 I, Derek Newton, have been appointed by RLCIS and CISGIL as the Independent Expert to consider the Scheme under Section 109 of FSMA. My appointment has been approved by the FSA; this was confirmed in a letter dated 19 October 2011 from the FSA to CBG. The PRA subsequently confirmed continuing approval for my appointment in a letter dated 26 June 2013. I have similarly been appointed by RLCIS and CISGIL as the Independent Actuary to consider the Jersey Scheme under Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996.
- 1.13 I am a Principal of Milliman LLP (“Milliman”) and I am based in its UK General Insurance practice in London. I am a Fellow of the Institute and Faculty of Actuaries which was established in 2010 by the merger of the Institute of Actuaries and the Faculty of Actuaries. I became a Fellow of the Institute of Actuaries in 1988. My experience of general insurance includes the (reserved) roles as the Signing Actuary to Lloyd’s syndicates and Irish non-life insurance companies. I have included my Curriculum Vitae in Appendix C. Although I have some life assurance experience, I have consulted with my colleagues within Milliman’s UK Life Assurance practice in respect of any matters regarding life assurance in respect of the Scheme.
- 1.14 I am not a member of the Co-operative Group and do not have, and have never had, any policies issued by any part of the Co-operative Group. Similarly, I do not have, and have never had, any policies issued by any part of Royal London. I have undertaken no work for RLCIS, CISGIL, Royal London or any other part of either the Co-operative Group or the Royal London Group.
- 1.15 Nick Dumbreck, a Principal of Milliman based in its UK Life Assurance practice, has acted as the With-Profits Actuary for RLCIS since October 2010, and between January 2010 and September 2010 was a member of the then newly created With-Profits Committee. Prior to the creation of the With-Profits Committee, Mike Arnold, who was then a Principal of Milliman based in its UK Life Assurance practice but who has since retired from Milliman, acted for RLCIS as the Independent Person for With-Profits Governance. In that role he was occasionally assisted by other members of Milliman’s UK Life Assurance practice. The work of Messrs Dumbreck and Arnold has related solely to the long-term business of RLCIS. Milliman has not been involved in any project relating to the general insurance or reinsurance business of either RLCIS or CISGIL.
- 1.16 Milliman’s UK Life Assurance practice has also performed some work in earlier years on behalf of Royal London.
- 1.17 The overall fee income that Milliman has received from the Co-operative Group and Royal London in any of the last 7 years (2006 to 2012) has not exceeded 0.075% of Milliman’s corresponding annual global revenue.

- 1.18 I do not believe that the involvement of other consultants within Milliman with CBG or Royal London affects my ability to act independently in my assessment of the Scheme.
- 1.19 The Scheme is subject to sanction by the High Court of Justice in England and Wales under Section 111 of FSMA. The Jersey Scheme is subject to sanction by the Royal Court of Jersey under Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996, and is conditional on the Scheme being effective.
- 1.20 CISGIL will be responsible for payment of all fees in respect of my work as Independent Expert and Independent Actuary.

## THE SCOPE OF MY REPORT

- 1.21 My terms of reference have been reviewed by the FSA and are set out in Appendix B.
- 1.22 I have considered the terms of the Schemes only and have not considered whether any other scheme or schemes may provide a more efficient or effective outcome.
- 1.23 The Report describes the Schemes and the likely effects on policyholders of RLCIS and CISGIL, including effects on security and levels of service.
- 1.24 The Report should be read in conjunction with the full terms of the Schemes.
- 1.25 My work has required an assessment of the liabilities of RLCIS and CISGIL for the purposes of describing the effect of the Schemes. My review of the liabilities was based on the actuarial reserve assessments conducted by internal actuaries of CISGIL and, on an independent basis, by external actuaries. I have reviewed the methodology and assumptions used in their work and assessed the key areas of uncertainty in relation to these liabilities. I have not attempted to review in detail the calculations performed by either the internal actuaries of CISGIL or the external actuaries or to produce independent estimates of the liabilities.
- 1.26 In addition to the liabilities, I have assessed the appropriateness in nature and amount of any assets to be transferred under the Schemes, and the capital position of RLCIS and CISGIL pre and post the Schemes. Again, I have not attempted to review in detail the calculations of the capital position performed by CISGIL or to produce independently my own estimates.
- 1.27 As far as I am aware, there are no matters which I have not taken into account in undertaking my assessment of the Schemes and in preparing the Report, but which nonetheless should be drawn to the attention of policyholders in their consideration of the Schemes.
- 1.28 In reporting on the Scheme as the Independent Expert, I recognise that I owe a duty to the Court to assist the Court on matters within my expertise. This duty overrides any obligation to RLCIS and / or to CISGIL. I confirm that I have complied with this duty.
- 1.29 Similarly, in reporting on the Jersey Scheme as the Independent Actuary, I recognise that I owe a duty to the Jersey Court to assist the Jersey Court on matters within my expertise. This duty overrides any obligation to RLCIS and / or to CISGIL. I confirm that I have complied with this duty.
- 1.30 I am aware of the requirements regarding experts set out in Part 35 of the Civil Procedure Rules, Practice Direction 35 and the Protocol for Instruction of Experts to give Evidence in Civil Claims.
- 1.31 I confirm that I have made clear which facts and matters referred to in the Report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.

- 1.32 Shortly before the date of the Court hearing at which an order sanctioning the Scheme will be sought, I will prepare a supplementary report (“the Supplementary Report”) covering any relevant matters which might have arisen since the date of the Report. It is intended that the Supplementary Report will be published on the CISGIL website at least one week before the date of the Court hearing. I understand that it will not be published on any website operated by Royal London but that the RLCIS website will include a link directing interested parties to the part of the CISGIL website that contains the Schemes-related information. I understand that the date of the Jersey Court hearing at which an order sanctioning the Jersey Scheme will be sought will be immediately after the date of the Court hearing for the sanctioning of the Scheme.

## THE STRUCTURE OF MY REPORT

- 1.33 The remainder of the Report is set out as follows:
- Section 2: I provide some background to the regulatory environment in which the companies involved in the Schemes operate.
  - Section 3: I provide some background to CBG and to the companies involved in the Schemes.
  - Section 4: I summarise the key provisions of the Schemes.
  - Section 5: I describe the matters I need to consider as Independent Expert and as Independent Actuary.
  - Section 6: I consider the likely impact of the Schemes on the transferring policyholders.
  - Section 7: I consider the likely impact of the Schemes on the policyholders of RLCIS who would remain within RLCIS after the transfer has taken place.
  - Section 8: I consider the likely impact of the Schemes on the current policyholders of CISGIL.
  - Section 9: I cover more general issues relating to the Schemes and the management of RLCIS and CISGIL.
- 1.34 I summarise my conclusions in Section 10.

## RELIANCES AND LIMITATIONS

- 1.35 In carrying out my review and producing the Report I have relied, without detailed verification, upon the accuracy and completeness of the data and information provided to me, in both written and oral form, by CISGIL and RLCIS. Reliance has been placed upon, but not limited to, the information detailed in Appendix D. My opinions depend on the substantial accuracy of this data, information and the underlying calculations. I am unaware of any issue that might cause me to doubt the accuracy of the data and other information provided to me. All information that I have requested in relation to my review has been provided. No responsibility is accepted for errors or omissions however arising in the preparation of the Report, provided that this shall not absolve my liability arising from an opinion expressed recklessly or in bad faith.
- 1.36 The Report has been prepared for the purposes of the Scheme in accordance with Section 109 of FSMA. A copy of the Report will be sent to the FCA and PRA, and will accompany the Scheme application to the Court. The Report has also been prepared for the purposes of the Jersey Scheme in accordance with Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996. A copy of the Report will accompany the Jersey Scheme application to the Jersey Court
- 1.37 The Report must be considered in its entirety as individual sections, if considered in isolation, may be misconstrued.

- 1.38 Neither the Report, nor any extract from it, may be published without me having provided my specific written consent, save that copies of the Report may be made available for inspection by policyholders and by the financial regulatory authorities in Jersey, Guernsey and the Isle of Man, and copies may be provided to any person requesting the same in accordance with legal requirements. I also consent to the Report being made available on the website to be operated by CBG in connection with the Scheme. I understand that the Report will not be available on any website operated by Royal London but that the RLCIS website will include a link directing interested parties to the part of the CISGIL website that contains the Schemes-related information. I have been shown the planned “home” page of the Royal London website which includes the link towards the bottom of the page under the heading “Important Information” and a sub-heading “Proposed transfer of the general insurance business of Royal London (CIS) Limited (formerly known as Co-operative Insurance Society Limited)”.
- 1.39 No summary of the Report may be made without my express consent. I will provide a summary of the Report for inclusion in a document that will be made available to policyholders of CISGIL and RLCIS under the Schemes (the “Report Summary”).
- 1.40 The Report has been prepared within the context of the assessment of the terms of the Schemes, and must not be relied upon for any other purpose. No liability will be accepted by Milliman, or me, for any application of the Report to a purpose for which it was not intended or for the results of any misunderstanding by any user of any aspect of the Report. In particular, no liability will be accepted by Milliman or me under the terms of the Contracts (Rights of Third Parties) Act 1999.
- 1.41 Actuarial estimates are subject to uncertainty from various sources, including changes in claim reporting patterns, claim settlement patterns, judicial decisions, legislation, economic and investment conditions. Therefore, it should be expected that the actual emergence of claims, premiums, expenses and investment income will vary from any estimate. Such variations in experience could have a significant effect on the results and conclusions of the Report. No warranty is given by Milliman or me that the assumptions, results and conclusions on which the Report is based will be reflected in actual future experience.
- 1.42 This review does not comprise an audit of the financial resources and liabilities of RLCIS or CISGIL.
- 1.43 The Report should not be construed as investment advice.
- 1.44 In considering the background to CBG and to the companies involved in the Schemes, and in considering the likely impact of the Schemes, I have made extensive use of financial information as at 31 December 2012 as that is the most recent date at which audited financial information is available. Several material developments have occurred in the period between 31 December 2012 and the date of the Report that have affected RLCIS and CBG, and I have referred to them in the Report. I have also taken into account updated financial information which has been made available to me, although I note that this updated information has not been audited<sup>1</sup>. At the date of the Report, I am not aware of any material changes in circumstances since 31 December 2012 other than those referred to in the Report. The Report also takes no account of any information that I have not received, or of any inaccuracies in the information provided to me.
- 1.45 The use of Milliman’s name, trademarks or service marks, or reference to Milliman directly or indirectly in any media release, public announcement or public disclosure, including in any promotional or marketing materials, websites or business presentations is not authorised without Milliman’s prior written consent for each such use or release, which consent shall be given in Milliman’s sole discretion.
- 1.46 The Report should not be used or relied upon for any purpose other than as the expression of my opinion on the impact of the Schemes in accordance with Section 109 of FSMA. I hereby expressly disclaim any liability to any party who relies or purports to rely on the Report for any other purpose whatsoever.

<sup>1</sup> Some of the updated information – for example, the reserves held by CISGIL as at 30 June 2013 – has been subject to review by the auditors as part of the auditors’ review opinion on the consolidated accounts of the Co-operative Group as at 30 June 2013.

## LEGAL OPINION

- 1.47 I have discussed with the senior management of CISGIL and RLCIS and their legal advisors those areas where I believe a legal view may be required. For those areas requiring legal input I have sought advice and comment from the legal advisers to RLCIS and CISGIL (in relation to the Schemes). I have reviewed the advice and comment so provided, and I consider that it was measured and appropriate.
- 1.48 Nevertheless, I retained another firm of lawyers which had not been otherwise involved with either CISGIL or RLCIS to provide wholly independent legal advice in relation to the Schemes, particularly on matters relating to the Indemnity Agreement.

## PROFESSIONAL AND REGULATORY GUIDANCE

- 1.49 I am required to comply with relevant professional standards and guidance issued by the Board for Actuarial Standards and the Institute and Faculty of Actuaries, including *Transformations Technical Actuarial Standard* (as published in December 2010), *Insurance Technical Actuarial Standard* (as published in October 2010), *Technical Actuarial Standard D: data* (as published in November 2009), *Technical Actuarial Standard M: modelling* (as published in April 2010) and *Technical Actuarial Standard R: reporting actuarial information* (as published in November 2009). I have complied with such standards, subject to the principles of proportionality and materiality.
- 1.50 The Report has been prepared under the terms of the guidance set out in Section 18 of the joint PRA/FCA Supervision Manual ("SUP18") contained in the Handbook of Rules and Guidance to cover scheme reports on the transfer of insurance business.

## 2. REGULATORY BACKGROUND

### INTRODUCTION

- 2.1 UK insurers, as well as other financial services organisations, are regulated by both the PRA and the FCA using a system of dual regulation. Between them, the PRA and the FCA have more than 4,000 employees and an annual budget of over £400 million.
- 2.2 The PRA and the FCA are statutory bodies set up under the Financial Services Act 2012 ("FinSA"). All regulatory responsibility was transferred from the FSA to the PRA and/or the FCA, as appropriate, effective 1 April 2013. This process was termed "legal cutover".
- 2.3 The PRA is part of the Bank of England and is responsible for:
- Prudential regulation of banks, building societies and credit unions, insurers and major investment firms;
  - Promoting the safety and soundness of the firms it regulates, seeking to minimise the adverse effects that they can have on the stability of the UK financial system; and
  - Contributing to ensuring that insurance policyholders are appropriately protected.
- 2.4 The FCA is a separate institution and is responsible for:
- Ensuring that its regulated markets function well;
  - Conduct regulation of all financial firms; and
  - Prudential regulation of those financial services firms that are not supervised by the PRA.
- 2.5 A Memorandum of Understanding ("MoU") has been established between the PRA and the FCA, which sets out the high level framework by which the two new regulatory bodies will co-ordinate. In particular, the MoU requires the PRA and FCA to co-ordinate with each other in advance of insurance business transfers under Part VII of FSMA.
- 2.6 The PRA sets the regulations governing the amount and quality of solvency capital held by firms; these are summarised below. The solvency regime is designed to protect the benefit security of policyholders, as well as the stability of the insurance industry.
- 2.7 The FCA is concerned with achieving fair outcomes for consumers and seeks to ensure that firms adhere to its conduct principles. Its operational objectives are:
- To secure an appropriate degree of protection for consumers;
  - To protect and enhance the integrity of the UK financial system; and
  - To promote effective competition in the interests of consumers.
- 2.8 For the purposes of the Report where I refer to the "Regulator" this should be taken to refer to the FCA and/or the PRA or (as their predecessor body) the FSA as appropriate.

### TAXATION

- 2.9 In the UK, general insurance companies are taxed on profits achieved at the main rate of corporation tax (currently 23.25%<sup>2</sup> for the calendar year ending 31 December 2013).

<sup>2</sup> The UK Corporation Tax rate is expected to reduce to 21.5% in 2014, 20.25% in 2015 and 20% from 2016 onwards.

## LONG-TERM AND GENERAL INSURANCE BUSINESS

- 2.10 Generally speaking, in the UK most general insurance business is underwritten by entities that specialise solely in such business; likewise long-term business is underwritten by specialist life assurers. However, a number of entities (“composites”) are authorised to write both long-term and general insurance business.
- 2.11 The natures of long-term and general insurance business, and the risks pertaining to them, differ from each other. To ensure that the respective interests of the long-term and general insurance policyholders are not prejudiced, PRA rules require the separate management of long-term and general insurance activities within all composites. In particular, profits from long-term business must benefit life policyholders as if the composite only pursued the activity of life assurance. Within composites, a separate long-term fund is maintained, containing all of the assets and liabilities that relate to the long-term business, and the assets therein can be used solely for the purpose of the long-term business. The general insurance assets and liabilities are contained within the remaining shareholders’ funds (which might themselves be subdivided into separate funds). While it is possible for shareholders’ assets to support the long-term fund, it is not permissible under PRA rules for the long-term fund to support the shareholders’ funds, other than through the shareholders and shareholders’ funds participating in the normal distribution of profits from the long-term fund.

## FINANCIAL SERVICES COMPENSATION SCHEME

- 2.12 As well as through the PRA and FCA regulations, consumer protection is also provided by the Financial Services Compensation Scheme (“FSCS”). This is a statutory “fund of last resort” which compensates customers in the event of the insolvency (or other defined default) of a financial services firm authorised by the PRA or FCA. Insurance protection exists for private policyholders and small businesses (those with annual turnover less than £1 million) in the situation when an insurer is unable to meet fully its liabilities. For general insurance business, the FSCS will pay 100% of any claim incurred before the wind-up under compulsory insurance (such as motor third party liability cover) and 90% of the claim incurred before the wind-up for non-compulsory insurance (such as home insurance, or the non-compulsory parts of motor insurance), without any maximum. The FSCS is funded by levies on firms authorised by the PRA.
- 2.13 In general, members of industrial and provident societies, as registered under the Industrial and Provident Societies Act 1965 (“I&P Act 1965”), do not have access to the FSCS. However, members of societies which are both registered under I&P Act 1965 and regulated by the PRA or FCA do have access to the FSCS.

## FINANCIAL OMBUDSMAN SERVICE

- 2.14 The Financial Ombudsman Service (“FOS”) provides private individuals (and micro enterprises<sup>3</sup>) with a free, independent service for resolving disputes with financial companies. It is not necessary for the private individual (or micro enterprise) to live or be based in the UK for a complaint regarding an insurance policy to be dealt with by the FOS; it is necessary for the insurance policy concerned to be, or have been, administered from within the UK.
- 2.15 In general, members of industrial and provident societies, as registered under I&P Act 1965, do not have access to the FOS. However, members of societies which are both registered under I&P Act 1965 and regulated by the PRA or FCA do have access to the FOS.

## RISK-BASED CAPITAL FRAMEWORK

- 2.16 At the end of 2004 the FSA introduced a risk-based capital framework (known as the ICAS framework) under which companies are required to assess solvency under two regimes, referred to as Pillar I and Pillar II. This framework is now supervised by the PRA.

<sup>3</sup> Micro-enterprises (an EU term covering smaller businesses) can bring complaints to FOS as long as they have an annual turnover of less than €2 million and fewer than ten employees.

## Pillar I

- 2.17 Under ICAS Pillar I, each insurer has both to meet statutory requirements based on EU Directives and to provide a more risk-based enhanced capital requirement (“ECR”) calculation to the PRA. This includes setting up Technical Provisions in accordance with those Directives and having sufficient available capital to meet at least the Minimum Capital Requirement (“MCR”). Composites calculate separate ECRs and MCRs for their long-term and general insurance businesses; those relating to general insurance business can only be met by assets outside of the long-term funds, although capital resources arising outside the long-term funds may be allocated towards long-term business.
- 2.18 Details of the calculation of the MCR as it relates to general insurance are given in Appendix G but essentially it comprises the greater of a premium measure, a claims measure, a prior year MCR measure, and a minimum amount, currently set at €3.7 million. The ECR is the sum of an asset charge, a premium charge and a charge for technical provisions less the claims equalisation reserve (“CER”). Insurers are not required to make publicly available their ECR calculation and supporting documentation insofar as it relates to non-life insurance. For long-term insurance business, insurers are required to show the ECR on Form 2 of their returns to the FSA.
- 2.19 The Technical Provisions required under the EU Directives as relating to general insurance business are:
- The unearned premium provision (“UPR”) – the UPR is the amount set aside from premiums written before the valuation date to cover risks incurred after that date;
  - The additional amount for unexpired risk (“URR”) – the URR is the amount held in excess of the UPR, to allow for any expectation as at the valuation date that the UPR will prove to be insufficient to cover the cost of claims and expenses incurred during the period of unexpired risk; and
  - The claims outstanding provision – the reserve set up in respect of the liability for all outstanding claims at the valuation date, whether reported or not.
- 2.20 The UPR is typically calculated on a daily basis (but alternative methods may be acceptable where the daily basis is not appropriate) and makes no allowance for the time value of money (i.e. discounting).
- 2.21 The claims outstanding provision typically comprises the case reserves plus the amount, if any, for claims incurred but not reported (“IBNR”) at the valuation date. Case reserves are the amounts estimated on a case-by-case basis as being required to settle reported (open) claims. The IBNR reserve is the amount estimated as being required to provide for:
- claims still to be reported to the insurer as at the valuation date which related to claim events that have occurred before that date; and
  - any perceived shortfall between the projected ultimate costs and the case estimates for claims already notified, although occasionally this provision is shown separately where it is often referred to as an “incurred but not enough reported” (“IBNER”) reserve.
- The IBNR (and IBNER) reserves would typically be evaluated using statistical techniques based on grouped data.
- 2.22 Under UK regulatory practices, only in particular limited circumstances may the claims outstanding provision estimate include any allowance for the time value of money (i.e. discounting). Therefore, all other things being equal, a margin exists in the provision to cover (at least in part) unexpectedly adverse claims development.

## Pillar II

- 2.23 The capital that must be held under Pillar II is an amount based upon the Individual Capital Assessment (“ICA”), which is the company’s own assessment of its capital requirements. Pillar II is intended to provide a more realistic and complete view (than is provided by the MCR under Pillar I) of the risks to which the company is exposed, and to provide a framework within which the company should be managed. The separate management of the long-term and general insurance businesses within composites necessitates these entities to prepare separate ICAs for the two business types.

- 2.24 The PRA requires each insurer, when preparing its ICA, to identify the major risks it faces and, where capital is appropriate to mitigate those risks, to quantify how much (and what type) of capital is appropriate. The PRA expects each insurer to conduct stress tests and scenario analyses in respect of each risk. The capital requirements so determined are then aggregated, allowing for diversification between risks where appropriate. These stress tests and scenario analyses, together with the supporting analysis, must be documented and, along with the results, submitted to the PRA (on request) as the ICA. The insurer is not required to publish its Pillar II capital requirement.
- 2.25 The PRA will review the ICA periodically and may prescribe an additional amount of capital that must be held by the insurer in addition to the ICA. The total amount of Pillar II capital prescribed by the PRA is called Individual Capital Guidance (“ICG”). The ICG is usually set as a percentage of the ECR, gross of CER. The ICG is not published and details of this remain private between the insurer and the PRA.
- 2.26 For the ICA, an insurer will assess the amount of capital it needs to hold to remain able to meet its liabilities as they fall due in all but extreme circumstances. The PRA has indicated that ICG will be given taking into consideration capital resources consistent with a 99.5% confidence level that the insurer will be able to meet its liabilities over a one-year timeframe or, if appropriate to the insurer’s business, an equivalent lower confidence level over a longer timeframe.

## FCA CONDUCT PRINCIPLES

- 2.27 Within its “*Journey to the FCA*” document, the FCA notes that it expects firms to continue to demonstrate that they are achieving the six consumer outcomes set out in an FSA document entitled “*Treating customers fairly – towards fair outcomes for consumers*” (“TCF”) published in July 2006. The aim of this document was to develop Principle 6 of the FSA’s Principles for Businesses (PRIN 2.1.1) which stated that each insurer “*must pay due regard to the interests of its customers and treat them fairly*”. Principle 7 outlines that each insurer “*must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading*” while Principle 8 states that each insurer “*must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client*”.
- 2.28 The TCF document lists six outcomes that collectively outline insurers’ regulatory obligations for the fair treatment of customers. These are as follows:
- Outcome 1: Consumers can be confident that they are dealing with insurers where the fair treatment of customers is central to the corporate culture;
  - Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;
  - Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;
  - Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances;
  - Outcome 5: Consumers are provided with products that perform as insurers have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and
  - Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by insurers to change product, switch provider, submit a claim or make a complaint.

## THE INSURERS (REORGANISATION AND WINDING UP) REGULATIONS 2004

- 2.29 Under UK law, the winding-up of an insurance undertaking is governed by the Insurers (Reorganisation and Winding Up) Regulations 2004. Under these regulations, insurance claims have precedence over any claim on the insurance undertaking with the exception of certain preferential claims (e.g. claims by employees, etc.) with respect to the whole of the insurance undertaking’s assets. Therefore, direct policyholders rank equally and above inwards reinsurance policyholders and all other unsecured/non preferential creditors in the event that an insurer is wound up.

## SOLVENCY II

- 2.30 The regulatory solvency reporting requirements for insurers and reinsurers regulated within the EU are due to undergo a major overhaul as they will need to meet the requirements of a new solvency regime that are currently being developed by the European Commission. This new regime is commonly referred to as Solvency II and aims to introduce, consistently across the EU, solvency requirements that reflect better than the existing solvency regimes the risks that insurers and reinsurers actually face. UK insurers and reinsurers will be required to adhere to the new capital requirements. There are similarities between the existing ICAS regime and the proposed Solvency II regime, but there are also significant differences. For example, in contrast to the position under the current UK Pillar II requirements, some of the results under Solvency II will be public. The formal date for full implementation of these new rules is expected to be in 2016, although it may be delayed further.
- 2.31 Like the ICAS regime, Solvency II has been formulated using the image of pillars supporting the overall regime. Solvency II will be based on three pillars:
- Under Pillar I, quantitative requirements define a market-consistent framework for valuing the assets and liabilities of insurers;
  - Under Pillar II, insurers must meet minimum standards for their corporate governance, and also for their risk and capital management. There is a requirement for permanent internal audit and actuarial functions. Insurers must each regularly complete an Own Risk and Solvency Assessment (“ORSA”);
  - Under Pillar III, there are explicit requirements governing disclosures to supervisors and policyholders.
- These pillars are different from those supporting the ICAS regime.
- 2.32 The Solvency Capital Requirement (“SCR”) under Solvency II is the amount of capital required to ensure continued solvency over a 1 year timeframe with a probability of 99.5%. The SCR is calculated based on the particular risks to which the insurer in question is exposed.
- 2.33 The Solvency II Minimum Capital Requirement (“MCR<sub>2</sub>”), which will be lower than the SCR, defines the trigger point for intensive regulatory intervention. The MCR<sub>2</sub> calculation is more formulaic and less risk sensitive than the SCR calculation.
- 2.34 The Solvency II rules have yet to be finalised. However, as currently drafted, they would maintain the requirement for composites to manage separately their long-term and general insurance business, and to calculate separate MCR<sub>2</sub> amounts. There are likely to be some changes, for example it is expected that the principle of the long-term fund would no longer be applied and instead funds applying to long-term and funds applying to general insurance would be ring-fenced.
- 2.35 The basis for the Solvency II calculations has not yet been finalised, although some illustrative calculations have been prepared by CISGIL to assess the likely impact of the new regime, based on the Solvency II rules that have so far been finalised and the latest draft of all other rules. I have discussed, at a high level, the likely impact of both of the Schemes on a Solvency II basis with the senior management of CISGIL. Through these discussions, consideration has been given to the likely change in financial strength under Solvency II as a result of the Schemes.

## THE FINANCIAL INFORMATION IN THE REPORT

- 2.36 The ICAS Pillar I balance sheet items as at 31 December 2012 are shown in Section 4. These have been published, externally audited and approved by the respective Boards of CISGIL and RLCIS.
- 2.37 As stated above, ICAS Pillar II financial information is not published and remains private between the PRA and the company. I have therefore reviewed this information and have commented on it in general terms, but I have not included any ICAS Pillar II figures in the Report.

### 3. BACKGROUND ON THE ENTITIES CONCERNED IN THE SCHEMES

#### RLCIS

##### Background

3.1 RLCIS (formerly Co-operative Insurance Society Limited) is an insurance company which was converted from an industrial and provident society into a private limited company in England and Wales (registered number 8629353), registered under the Companies Act 2006. It is a subsidiary of Royal London (registered number 99064). RLCIS was previously part of the Co-operative Group until it was sold to Royal London on 31 July 2013. Both RLCIS and Royal London are jointly regulated by the PRA and FCA. RLCIS is authorised to write both life and general insurance and reinsurance business, although it ceased writing new and renewal general insurance and reinsurance business with effect from 15 January 2006 (it continues to write life business).

##### Types of business written

3.2 Prior to 15 January 2006, RLCIS wrote a general insurance and reinsurance portfolio comprising mostly the following insurance types (percentages in brackets are the proportions of the total gross undiscounted outstanding general insurance claim reserves as at 31 December 2012, which amounted to £144.7 million<sup>4</sup>):

- Personal Lines Motor (79%);
- Commercial Lines Motor (14%),
- Household and Domestic Risks (2%); and
- Commercial Lines Liability (5%).

The above types were all direct business; they did not include inwards reinsurance business.

3.3 In addition, the portfolio included relatively small amounts of:

- Accident & Health insurance;
- Commercial Property insurance;
- Financial Loss insurance (both personal lines and commercial lines); and
- Treaty reinsurance business accepted (both proportional and non-proportional).

3.4 The Treaty reinsurance business accepted includes covers in respect of accident & health, property, marine, transport and aviation business.

3.5 The direct general insurance business of RLCIS was written largely in the UK, but some covers were also written in Guernsey, Jersey and the Isle of Man.

3.6 As at 31 December 2012, 48 inwards<sup>5</sup> reinsurance contracts remained open. Of these, 37 had been written under English law or under the laws of other EEA member states. I have been informed that, of the 11 written under laws of countries outside of the EEA, CBG has in-principle agreements with the writers of 6 of the contracts for them to be novated to CISGIL, and is currently working on achieving novation to CISGIL of the remaining 5 inwards reinsurance contracts (the legal frameworks involved are those of Hong Kong, Japan and the USA). Other inwards reinsurance contracts were written that are now deemed by RLCIS to be closed but under which there is a remote possibility that claims might still arise. No inwards reinsurance contracts have been written under Jersey law.

<sup>4</sup> Based on Form 20A, line 20, columns 2 & 3, of RLCIS's Returns to the FSA as at 31 December 2012

<sup>5</sup> "Inwards" reinsurance contracts are those written by an (re)insurer, providing cover to third party insurers. "Outwards" reinsurance contracts are those bought by an insurer from third parties, providing it with cover.

- 3.7 RLCIS now covers no unexpired general insurance or reinsurance risks. No general insurance or reinsurance premium income is now received by RLCIS, save for very small amounts of adjustment premiums on some non-proportional contracts and other small amounts of residual premiums on the inwards reinsurance business caused by accounting delays. The majority of the outstanding general insurance and reinsurance claim reserves relate to personal injury claims that are long-tail in nature, given that it may take many years for a policyholder's injury or harm to become known. Over 90% of the outstanding general insurance and reinsurance gross undiscounted claim reserves relate to motor insurance, with the remainder relating mostly to commercial liability and a small proportion relating to domestic risks.
- 3.8 Of the 48 separate inwards Treaty reinsurance contracts that remained open as at 31 December 2012, just 3 accounted for 50% of the £1.2 million reserve for outstanding liability attributable to inwards reinsurance. 14 other treaties have outstanding liabilities estimated to be less than £1,000 each. The reserves as at 31 December 2012 for the 5 non-EEA contracts for which, at the time of writing the Report, novation had not been agreed, even in principle, totalled £0.2 million.
- 3.9 Although RLCIS has written business within the London Market, CBG has informed me that, prior to the sale of RLCIS to Royal London, it had found no evidence that any ILU guarantees<sup>6</sup> were issued by RLCIS. CBG has also informed me that, although some of RLCIS's inwards Treaty reinsurance business covers risks situated in the United States, none of it was set up within U.S. Situs Trust Funds.
- 3.10 RLCIS has also written, and continues to write, life business, covering both long-term and pensions-related products. This business is now written only in the UK although some business currently in-force was written in the Channel Islands and the Isle of Man. The life business will not be transferred as part of the Scheme.

#### Key financial information

- 3.11 As at 31 December 2012 the gross outstanding general insurance and reinsurance claims reserves within RLCIS were £144.7 million<sup>7</sup> (£86.6 million after discounting<sup>8</sup>), of which:
- £1.2 million (no discounting) related to Treaty reinsurance business accepted;
  - £113.7 million (£71.9 million after discounting) related to Personal Lines Motor;
  - £19.8 million (£4.8 million after discounting) related to Commercial Lines Motor;
  - £7.6 million (£6.2 million after discounting) related to Commercial Lines Liability;
  - £2.3 million (no discounting) related to Personal Lines Household; and
  - £0.1 million (no discounting) related to other business (mostly Commercial Lines Property).

According to the Indemnity Agreement, CISGIL shall meet the future payments of RLCIS in respect of the outstanding general insurance or inwards reinsurance claims, and shall benefit from any recoveries on those claims that would have been made by RLCIS against third party reinsurers. As a result, as at 31 December 2012, the net outstanding general insurance and inwards reinsurance claims reserve within RLCIS was zero. In effect, the general insurance and reinsurance liabilities written prior to CISGIL's establishment remained with RLCIS but the economic risk was transferred from RLCIS to CISGIL by means of the Indemnity Agreement.

<sup>6</sup> These were guarantees required by the Institute of London Underwriters ("ILU") in relation to liabilities under ILU policies. The guarantee can be drawn upon by the ILU in the event of the insurer's default on any payment in relation to the policy in question. The ILU was merged with the London International Insurance and Reinsurance Market Association in January 1998 to form the International Underwriting association ("IUA").

<sup>7</sup> Based on Form 20A, line 20, columns 2 & 3, of RLCIS's Returns to the FSA as at 31 December 2012

<sup>8</sup> Based on Form 15, line 12, less line 82 of RLCIS's Returns to the FSA as at 31 December 2012

- 3.12 As at 31 December 2012 there were no outstanding claims relating to RLCIS's Jersey Business. The gross claims reserves within RLCIS in respect of all general insurance and reinsurance business includes a small amount relating to claims that have been incurred but not yet reported ("IBNR"). Were this gross IBNR reserve to be hypothecated between the various parts of RLCIS's general insurance and reinsurance business then I have been told that a small proportion would be hypothecated to RLCIS's Jersey Business. I understand from CBG that the gross claims reserves attributable in this way to RLCIS's Jersey Business would be negligible. I have therefore not considered them further in this Section of the Report.
- 3.13 As at 31 December 2012 the total liabilities in respect of the long-term business within RLCIS were £18,882.3 million, gross of reinsurance, and £15,283.9 million, net of reinsurance<sup>9</sup>.
- 3.14 RLCIS's reported gross general insurance and reinsurance liabilities are declining as the claims run-off, as demonstrated by the following total gross undiscounted outstanding general insurance and reinsurance claim reserves:
- As at 10 January 2009: £331.9 million
  - As at 31 December 2009: £278.4 million
  - As at 31 December 2010: £214.1 million
  - As at 31 December 2011: £156.7 million
  - As at 31 December 2012: £144.7 million.
- 3.15 Over the same period, RLCIS's reported gross long-term liabilities have remained broadly level (at least until 2011 when they increased by just over 10%, but then fell back by 4% during 2012), as demonstrated by the following total gross total liabilities in respect of the long-term business:
- As at 10 January 2009: £17,807.5 million
  - As at 31 December 2009: £16,855.1 million
  - As at 31 December 2010: £17,755.9 million
  - As at 31 December 2011: £19,624.2 million
  - As at 31 December 2012: £18,882.3 million.
- 3.16 As at 31 December 2012, the total admissible assets of RLCIS (in respect of business other than long-term), including the reinsurers' share of the technical provisions, amounted to £326.6 million<sup>10</sup>. Of this, £200.0 million had been notionally hypothecated for the purposes of the Returns to the FSA to the long-term business, despite arising outside the long-term fund, which left RLCIS with capital resources available to meet the regulatory capital requirements relating to the general insurance and reinsurance business of £38.6 million<sup>11</sup> compared with a statutory MCR for the general insurance and reinsurance business of £9.0 million<sup>12</sup>, i.e. the assets in excess of regulatory requirements as at 31 December 2012 were £29.6 million. This implied cover for the MCR (assets available to meet the MCR divided by the MCR) of 429% as at 31 December 2012. The £200.0 million notionally hypothecated to the long-term business comprised assets that collectively are referred to within RLCIS as "the General Reserve", and forms all of the General Reserve. On completion of the sale and purchase of RLCIS, the capital resources available to meet the regulatory capital requirements relating to the general insurance and reinsurance business in RLCIS were reduced to £11.5 million. This amount still provided cover for the MCR as at 31 December 2012 of 128%.

<sup>9</sup> Based on Form 14, lines 11, 49 and 74 of RLCIS's Returns to the FSA as at 31 December 2012 (less line 73 for the net of reinsurance figure)

<sup>10</sup> Based on Form 13, Line 89 of RLCIS's Returns to the FSA as at 31 December 2012

<sup>11</sup> Based on Form 1, Line 13 of RLCIS's Returns to the FSA as at 31 December 2012

<sup>12</sup> Based on Form 1, Line 36 of RLCIS's Returns to the FSA as at 31 December 2012

- 3.17 As at 31 December 2012, the total long-term business admissible assets of RLCIS were £20,087.7 million<sup>13</sup>, RLCIS had capital resources available to meet the regulatory capital requirements relating to the long-term business of £3,621.7 million<sup>14</sup> compared with a statutory MCR of £564.2 million<sup>15</sup>, and an ECR of £2,416.8 million<sup>16</sup>, i.e. RLCIS held available assets that were in excess of the regulatory requirements relating to the long-term fund as at 31 December 2012. The cover for the long-term business ECR (assets available to meet the ECR divided by the ECR) was therefore 150%.
- 3.18 I note that, other than as mentioned in paragraph 1.44 above, I have seen no financial information relating to RLCIS that has been updated since 31 December 2012.

### The General Reserve

- 3.19 I have seen a document prepared in 2004 which noted that general insurance policies written up to that date included the following wording:
- “Claims under this Policy will be met from our Share Capital, General Business and General Reserve only”.*
- Similarly, long-term business policies contained the following wording:
- “The benefits provided by this Policy can be met from only out of our Ordinary Long Term Fund, together with our Share Capital and General Reserve fund”.*
- This indicates that both the long-term business and the general insurance and reinsurance business could access the Share Capital and General Reserve in extreme solvency scenarios in order to meet the cost of claims arising.
- 3.20 I have been told that the wording in policy documents was altered for RLCIS general insurance policies written from shortly after the above document had been issued and that references to the General Reserve were removed. However, any claim relating to a general insurance or reinsurance policy written before this wording change would have been entitled to support from the General Reserve, insofar as any General Reserve were then available, if the General Business Reserve and Share Capital proved inadequate to meet the cost of the claims. A significant portion of the claims relating to general insurance and reinsurance business that were outstanding as at 31 December 2012 would relate to policies written before this change in policy wording. Thus, as at 31 December 2012, the assets available, inclusive of the General Reserve, to meet the regulatory capital requirements relating to the general insurance and reinsurance business could have been as large as £238.6 million which would mean that the cover for the MCR (in respect of the business other than long-term) would have been more than 2,600% as at that date. As pointed out in paragraph 3.19 above, the general insurance and reinsurance policyholders would not have had exclusive access to these assets, as the long-term business fund would also have had access rights in extreme solvency situations.
- 3.21 I understand that there has been considerable discussion, involving CBG, external lawyers, the FSA and the PRA, regarding the General Reserve and, in particular, any expectations that policyholders, or specific groups of policyholders, might have in respect of it. I have been told that such discussions have focused on whether representations might have been made in the past to policyholders that the General Reserve would “support the solvency” of RLCIS’s insurance funds and help RLCIS in “meeting solvency requirements”.
- 3.22 I have seen an opinion from a Queen’s Counsel (“QC”) that there is no obligation on RLCIS to maintain the General Reserve at any particular level. The QC’s opinion was sought by CBG in 2004 (and again in 2005). I have been informed that no contrary external legal opinions have been subsequently expressed to CBG (or Royal London) on this subject.

<sup>13</sup> Based on Form 13, line 89 of RLCIS’s Returns to the FSA as at 31 December 2012

<sup>14</sup> Based on Form 2, Line 13 of RLCIS’s Returns to the FSA as at 31 December 2012

<sup>15</sup> Based on Form 2, Line 36 of RLCIS’s Returns to the FSA as at 31 December 2012

<sup>16</sup> Based on Form 2, Line 40 of RLCIS’s Returns to the FSA as at 31 December 2012

- 3.23 I am not a legal expert and am not qualified to comment on particular legal aspects of, or that affect, the Schemes. However, I have assumed throughout the remainder of the Report the validity of the opinion summarised in paragraph 3.22 above and the implication of it that, subject to RLCIS maintaining adequate reserves and solvency margins on an on-going basis, RLCIS can use the General Reserve as it wishes. As such, I regard any assurance regarding solvency that is provided by the existence and level of the General Reserve to be transitory. It is expected that the validity of the opinion summarised in paragraph 3.22 above will be considered by the Court as part of another business transfer that is being planned by Royal London and which is discussed in paragraph 3.25 below.

### Provisions of the Sale and Purchase Agreement

- 3.24 In accordance with Clause 10.5 of the Sale and Purchase Agreement relating to the sale by CBG of RLCIS to Royal London ("the SPA"), Royal London has undertaken to maintain within RLCIS the minimum assets required for RLCIS to meet its minimum regulatory capital requirements in respect of its general insurance and reinsurance business plus 10% of such amount ("GI Capital Support Sum"). In other words, Royal London has undertaken to maintain the cover for the MCR (in respect of the general insurance business of RLCIS) at a level of at least 10% above the then minimum regulatory capital requirements. The period of this undertaking by Royal London (the "GI Capital Support Period") will last to the earlier of: (i) the Option Sale Date (see paragraph 3.25 below); and (ii) the date on which the Royal London and CBG agree an alternative means of funding the General Insurance Business capital requirement, or as otherwise agreed between Royal London and CBG.
- 3.25 After the Schemes have been completed, it is intended that no general insurance or reinsurance contracts will remain within RLCIS. However, there are several contracts that were written by RLCIS which are subject to governing laws that might not recognise the effectiveness of a Part VII transfer and which therefore might remain within RLCIS after the Effective Date of the Schemes, notwithstanding that they are included in the Schemes and that the English Court Order will purport to transfer them to CISGIL. Any such policies are referred to in the Report as "Excluded Policies". I have been told that it is Royal London's intention to effect as soon as possible a transfer scheme as defined in Section 105 of FSMA whereby all Long-Term Business within RLCIS will be transferred to Royal London ("the LTBF Scheme"). The SPA contained a put option and a call option whereby, within two years of completion of the LTBF Scheme, Royal London can require CBGL to buy back RLCIS and whereby CBGL can require Royal London to sell back RLCIS, respectively. That option can only be exercised should the Schemes (i.e. those relating to the general insurance and reinsurance business) not take place or should RLCIS, post the Effective Date of the Schemes, have to maintain regulatory capital in respect of any remaining Excluded Policies. If either the put or call option were exercised, the date on which the sale of RLCIS to CBG would be completed would be known as the "Option Sale Date".
- 3.26 I understand that, in the event that neither of the Schemes nor the LTBF Scheme were to take place, Royal London's options would be:
- 3.26.1 To seek another general insurance company with which to effect a Part VII transfer of RLCIS's general insurance and reinsurance business.
- 3.26.2 To continue to manage the business in run-off with the Indemnity Agreement still in place whereby CISGIL manages all claims and meets all liability payments.

### Eurozone exposures

- 3.27 I have been told that RLCIS has no direct credit exposure to sovereign debt or financial institutions in Greece, Portugal, Ireland, Italy or Belgium, and that it has no direct exposure to sovereign debt in Spain. It has some direct credit exposure to financial institutions in Spain, which is closely monitored and currently represents 0.4% of the long-term fund.
- 3.28 As at the 2012 year-end, RLCIS management had no detailed knowledge of indirect exposure to European sovereign debt (other than UK). I have been told that RLCIS manages its indirect exposure to European sovereign debt as and when knowledge emerges of an institution to which RLCIS is exposed itself having direct exposure to such debt. At this point, if the exposure is considered to be in excess of RLCIS's risk appetite, RLCIS will take action to reduce the risk through the sale of the relevant holdings.

### Reinsurance arrangements

- 3.29 Prior to its closure to new and renewal business, RLCIS had in place an outwards non-proportional reinsurance programme to protect it against liabilities arising from the direct policies which it had written. This programme had been broadly unchanged for several years and essentially provided Excess of Loss cover on each and every Motor claim for amounts above £5 million and on each and every Employers' or Public Liability claim for amounts above £2 million (these amounts are subject to indexation). RLCIS also had a small number of individual facultative contracts and it had a proportional reinsurance programme which has now closed.
- 3.30 Under the terms of the Indemnity Agreement, CISGIL shall meet the future payments of RLCIS in respect of the outstanding general insurance and reinsurance claims, and shall benefit from any recoveries on those claims that would have been made by RLCIS against third party reinsurers. This is an indemnification agreement, not a reinsurance arrangement, although it has been treated as if it were a reinsurance contract in RLCIS's Returns to the FSA.
- 3.31 Under RLCIS's outwards reinsurance programme, there were, as at 31 December 2012, 15 open claims that had been notified to reinsurers, in accordance with the applicable contract clauses. There are no open claims covered by the facultative contracts. As at 31 December 2012, the total outstanding recoverable under these third party reinsurance arrangements was £43.4 million on an undiscounted basis (£21.8 million on a discounted basis).

### Outsourcing arrangements

- 3.32 The administration and accounting of RLCIS's general insurance and reinsurance business is outsourced to CISGIL under the terms of the Indemnity Agreement. I have been informed that CBG undertook an extensive review of the servicing of general insurance and reinsurance business. As a result of that review, all material third parties external to CBG that are providing services relating to RLCIS's general insurance and reinsurance liabilities now have contractual relationships with CISGIL or another entity within CBG, not with RLCIS.
- 3.33 RLCIS prepares the statutory accounts and FSA Returns (which from the 2013 year-end will be returns to the PRA) in respect of the general insurance and reinsurance business on the basis of information provided by CISGIL.

## CISGIL

### Background

- 3.34 CISGIL is an industrial and provident society formed in England and Wales (registered number 29999R), both registered under I&P Act 1965 and regulated jointly by the PRA and FCA. It is a subsidiary of CBGL, which is itself a subsidiary of Co-operative Group Limited. It is authorised to write general insurance and reinsurance business. It is not authorised to write life business. It is the only operation within the Co-operative Group that is currently writing general insurance business.
- 3.35 The main elements of the business are as follows (percentages in brackets are the proportions of total gross premiums written in 2012 which total £555.7 million<sup>17</sup>):
- Personal Lines Motor (61%); and
  - Household and Domestic Risks (30%).
- 3.36 These two classes also comprise 83% and 7% respectively of the total gross undiscounted claims outstanding amounts as at 31 December 2012. 7% is also attributable to Commercial Motor although this class is not written in material volumes.
- 3.37 In addition, the portfolio included small volumes of the following business types:
- Accident & Health (including Travel);
  - Income Protection (including Legal Expenses and Creditor);

<sup>17</sup> Based on Form 20A of CISGIL's Returns to the FSA as at 31 December 2012

- Commercial Property;
- Commercial Lines Liability; and
- Inwards Treaty reinsurance (both proportional and non-proportional).

The Treaty reinsurance business accepted includes covers in respect of Accident & Health, Property, Marine, Transport and Aviation business. It is entirely business written by RLCIS and covered by CISGIL under the terms of the Indemnity Agreement. CISGIL only wrote inwards reinsurance business itself during the period January – July 2006. I have been informed by CBG that all of the inwards reinsurance business written by CISGIL is now closed and that no outstanding liability is assumed in respect of this business.

- 3.38 The active business of CISGIL is and has been written mostly in the UK, although CISGIL has also been licenced to write business in Guernsey, Jersey and the Isle of Man.
- 3.39 As at the date of writing the Report, CISGIL does not have a credit rating as provided by any of the recognised rating agencies such as Standard & Poor's.

### Key financial information

- 3.40 As at 31 December 2012 the gross outstanding general insurance and reinsurance claims reserves within CISGIL were £733.7 million<sup>18</sup> (£676.4 million after discounting), of which:

- £1.2 million (no discounting) related to Treaty reinsurance business accepted;
- £612.0 million (£570.5 million after discounting) related to Personal Lines Motor;
- £48.1 million (no discounting) related to Household and Domestic Risks;
- £51.4 million (£37.1 million after discounting) related to Commercial Lines Motor; and
- £21.0 million (£19.7 million after discounting) related to other business.

The gross outstanding general insurance and reinsurance claims reserves within CISGIL as at 31 December 2012 include those relating to business originally written by RLCIS and now fully indemnified by CISGIL. The above figures are net of salvage and subrogation.

- 3.41 As at 31 December 2012, the most recent date for which full financial information on CISGIL is available, the Technical Provisions of CISGIL consisted of<sup>19</sup>:

- Unearned premiums amounting to £272.6 million, gross of reinsurance (£270.4 million net of reinsurance);
- Claims outstanding provisions amounting to £756.1 million, gross of reinsurance (£713.5 million net of reinsurance) and of salvage and subrogation (which amounted to £61.3 million); and
- Equalisation provisions amounting to £29.5 million (both gross and net of reinsurance).

Together, the discounted gross technical provisions amounted to £1,058.2 million. In addition, there were as at 31 December 2012 other provisions and creditors amounting to £47.0 million, resulting in total undiscounted gross provisions, non-technical and technical, of £1,105.2 million.

<sup>18</sup> Based on Form 22 of CISGIL's Returns to the FSA as at 31 December 2012

<sup>19</sup> Based on Form 15 of CISGIL's Returns to the FSA as at 31 December 2012

- 3.42 As at 31 December 2012, the total admissible assets of CISGIL, including the reinsurers' share of the technical provisions, amounted to £1,430.6 million<sup>20</sup>, which left CISGIL with capital resources (i.e. assets available to meet the regulatory capital requirements relating to the general insurance and reinsurance business) of £324.0 million<sup>21</sup> compared with a statutory minimum capital requirement of £205.2 million<sup>22</sup>, i.e. the assets in excess of regulatory requirements as at 31 December 2012 were £118.9 million. The cover for the MCR (defined as the assets available to meet the regulatory capital requirements expressed as a proportion of the MCR) is 158%. I note that the MCR as at 31 December 2006 was set at an unusually high level, due to the one-off impact of the Indemnity Agreement on the premium measure and the claim measure within the MCR calculation. The MCR at each subsequent year-end has been equal to the prior year MCR measure, which has been significantly above both the premium measure and the claim measure applicable as at the respective year-ends. As at 31 December 2012 the premium measure was £96 million and the claim measure was £105 million,
- 3.43 As at 30 June 2013 the gross outstanding general insurance and reinsurance claims reserves within CISGIL were £651 million after discounting<sup>23</sup>.

### Eurozone exposures

- 3.44 I have been told that CISGIL has no liabilities that relate to the Eurozone and no direct credit exposure to sovereign debt for European countries. As at the 2012 year-end, CISGIL management had no detailed knowledge of indirect exposure to non-UK European sovereign debt.
- 3.45 I have been told that CISGIL manages its indirect exposure to European sovereign debt as and when knowledge emerges of an institution to which CISGIL is exposed itself having direct exposure to such debt. At this point, if the exposure is considered to be in excess of CISGIL's risk appetite, CISGIL will take action to reduce the risk through the sale of the relevant holdings.

### Reinsurance

- 3.46 CBG has in place a reinsurance risk policy that governs the criteria and techniques used to decide what reinsurance to buy and from whom it should be bought. This policy is endorsed by the Risk Management Committee as part of CBG's overall Risk Management Policy and any changes made are subject to sign-off by that Committee.
- 3.47 Reinsurance programmes cover each of CISGIL's main business areas including Accident & Health, Personal Lines Motor, Personal Lines Property, Personal Lines Financial Loss, Commercial Lines Motor, Commercial Lines Property, Commercial Lines Liability and Commercial Lines Financial Loss. I have summarised in Appendix I my understanding of the programme that applied to the 2012 accident year. The programmes relating to earlier accident years appear to have similar shapes, albeit with some variation between the years in the retention limits and other details.
- 3.48 For the financial year ended 31 December 2012, the external reinsurers providing the cover set out in Appendix I received 5.3% (£29.4 million) of CISGIL's gross written premiums. Over a third of this premium is applied to protect CISGIL in respect of its more minor lines of business; in contrast Motor insurance comprises 61% of the inwards gross written premiums but only 28% of the premiums ceded to reinsurers. As at 31 December 2012, the major external treaty reinsurers were Lloyd's, Faraday Re, Swiss Re, Hannover Re, Validus Re and R&V Re. There has been broad consistency from year-to-year in the list of reinsurers on the programme.

### Risks

- 3.49 CISGIL is exposed to a large number of risks in the course of its operations. The key risks may be classified under the headings of insurance (both underwriting and reserving), market, credit, operational, and pension scheme risk.

<sup>20</sup> Based on Form 13, Line 89 of CISGIL's Returns to the FSA as at 31 December 2012

<sup>21</sup> Based on Form 1, Line 13 of CISGIL's Returns to the FSA as at 31 December 2012

<sup>22</sup> Based on Form 1, Line 36 of CISGIL's Returns to the FSA as at 31 December 2012

<sup>23</sup> Based on KPMG's Report to the Board in respect of CISGIL for the half-year ended 30 June 2013, dated 19 August 2013

- 3.50 Insurance risk comprises:
- **Attritional claims risk:** the risk that there are more attritional claims than expected or that the average cost of those claims is more than expected in the pricing of the covers and in the strategic plan.
  - **Catastrophe risk:** the risk that the ultimate cost of catastrophe claims is greater than expected in pricing and in the strategic plan. The catastrophes to which CISGIL is exposed are all weather-related: inland flood, storm and freeze.
  - **Large claims risk:** the risk that the number of large claims (defined by CISGIL as being those with an ultimate cost in excess of £100,000 in current values) which occur is greater than expected, or that the ultimate cost of those claims is greater than expected in pricing and in the strategic plan.
  - **Subsidence risk:** the risk that there are more subsidence claims than expected, the average cost of those claims is higher than expected or the reinsurance premiums are higher than expected in pricing and in the strategic plan.
  - **Volume risk:** the volume of business underwritten differs materially from that expected in pricing and in the strategic plan.
  - **Reserving risk:** the risk that the reserves set at the start of the projection period prove to be inadequate. This includes risks associated with other elements of the ICA model, notably the impact of varying interest rates, claims inflation, claims handling expenses, reinsurance default risk and salvage and subrogation. I note that within the booked reserves there is already an explicit management margin which CISGIL uses to fund partially the required solvency capital. This margin is not a public figure. I have further discussed elements within the reserving risk in Section 6 below.
- 3.51 Market risk for CISGIL reflects the risk of a fall in the market value of the assets in the CISGIL fund over the course of a year due to an increase in overall yields and/or an increase in credit spreads on corporate bonds and/or defaults on bonds. A decrease in the value of the assets backing the insurance contracts could adversely affect the financial position of CISGIL to the extent that movement (in particular, a fall) in asset values were not matched by a corresponding movement in liability values.
- 3.52 Credit risk comprises the risk that a reinsurer fails to make promised payments either wholly or partly.
- 3.53 The main elements of pension scheme risk are that inflation and salary increases outstrip investment return, and that increased longevity causes pensions to be paid for longer than expected. Of the two risk elements, that relating to inflation and salary is considered the greater in magnitude.
- 3.54 Operational risks are the risks to which CISGIL is exposed during its day-to-day operations, mainly arising from possible failures of control and external events.
- 3.55 Because the above risks are not wholly correlated with one another, CISGIL takes credit in its ICA calculation for some risk diversification.
- 3.56 CISGIL has considered other types of risk (liquidity and group risks) and has decided that no specific capital should be held against them. CISGIL's reasoning is as follows:
- **Liquidity Risk:** CISGIL has assessed its exposure to liquidity risk as being negligible. Regardless of its actual exposure to liquidity risk, CISGIL also considers liquidity as something to be managed and mitigated through appropriate systems and controls rather than holding required capital as a suitable mitigating factor;

- Group Risk: No specific capital is currently held against contagion risk, on the basis that other CBG entities have sufficient capital to cover their regulatory requirements and a capital buffer is held at the CBGL level, which I have been told would be used as the first source of capital support if required by the other CBG entities. I have been shown a schedule summarising the CBGL balance sheet as at 31 December 2012 and then as at each subsequent month-end to 31 October 2013 (the figures post 31 December 2012 are unaudited). This indicates that there has been little change in the relative strength of the CBGL balance sheet over the course of the year to date. Moreover, no specific capital is currently held against reputational risk, on the basis that the potential impacts from these risks are already captured in the other risk categories' capital assessments.

As at the date of the Report, CBG has been receiving, and continues to receive, considerable negative publicity. I have been told that significant operational changes are being made within CBG and that further changes are planned. This situation and the on-going developments have increased the risk of solvency problems within CBG. I have discussed this with CBG management. Aside from the reputational risk arising from continuing negative publicity, which I understand would affect primarily CISGIL's new business, the contagion risk to which CISGIL appears most exposed would be the impact of a failure of CFS Management Services Limited ("CFSMSL"), which provides certain services to CISGIL (see paragraph 3.66 below) and which is wholly owned by CBGL. I have been told that the CISGIL Board which has obtained from the CBGL Board assurance that these services would be maintained to facilitate an orderly resolution if continuity were threatened, and that CISGIL's management team continues to monitor the position closely. Any other issues that might arise within CBG should not impact CISGIL operationally or financially to the point of jeopardising its ability to meet its statutory solvency requirements.

3.57 The Board-approved risk appetite is two-fold:

- That the probability of falling below regulatory required capital is no more than 15%; and
- That the probability of making an operating loss (excluding significant expenses) in any one year is no more than 25%.

3.58 There are a range of actions that CISGIL management can take, and has taken, to mitigate the risks facing the business. For example, CISGIL uses techniques which include appropriate asset liability management strategies and monitoring the financial strength of its reinsurers (including those to whom risks are no longer ceded).

### Indemnity Agreement

3.59 CISGIL and RLCIS are parties to the Indemnity Agreement whereby they agreed, with effect from 15 January 2006, the following:

3.59.1 CISGIL would indemnify RLCIS in respect of all "Covered Losses" (i.e. any amounts insured or paid or falling to be paid on or after 15 January 2006 which RLCIS was contractually liable to pay pursuant to any of the insurance policies that it wrote, or any other costs, expenses, etc. (excluding tax payments) connected with those policies). As such, CISGIL would meet all Covered Losses when due, making payments to the persons owed by RLCIS, rather than making payments via RLCIS.

3.59.2 Where all or any part of any Covered Loss were recovered by RLCIS (e.g. through salvage or via a reinsurance contract), RLCIS would promptly pay to CISGIL an amount equal to the amount recovered. All of RLCIS's rights relating to recoveries in respect of any Covered Loss would be subrogated to CISGIL.

3.59.3 CISGIL would assume the management of all insurance and (both inwards and outwards) reinsurance policies written by RLCIS, including the collection and payment of premiums and commissions, the negotiation of amendments or endorsements to any of the inwards or outwards policies, and all aspects of claims handling and management.

3.60 In exchange for this, an amount equal to the net technical provisions was paid by RLCIS to CISGIL and has been maintained in a separate account, from which and to which flow all payments made and received in respect of the Covered Losses.

- 3.61 The Indemnity Agreement makes clear that its intention is, so far as is possible, to transfer to CISGIL the benefits and burdens of RLCIS in respect of RLCIS's general insurance and reinsurance obligations.
- 3.62 The Deed of Amendment and Restatement, signed on 31 July 2013, restated the Indemnity Agreement to accommodate the fact that, from that point onwards, the arrangement would no longer be an intra-group indemnity. The Deed of Amendment and Restatement also provided that, from the date of signing, CBGL guarantees to RLCIS the due and punctual performance of each obligation of CISGIL, including the payment to RLCIS of any sum of money that, according to the Indemnity Agreement, CISGIL should have paid but has not.
- 3.63 As discussed in paragraph 3.25 above, there are some contracts that were written by RLCIS which are subject to governing laws that might not recognise the effectiveness of either of the Schemes and which therefore might remain within RLCIS after the Effective Date of the Schemes. The Indemnity Agreement will remain in force after the Effective Date and will continue to transfer to CISGIL the benefits and burdens of RLCIS in respect of any such Excluded Policies.
- 3.64 As I have mentioned in paragraph 1.48 above, I retained an independent firm of lawyers which reviewed the Indemnity Agreement (as amended by the Deed of Amendment and Restatement). It confirmed my understanding of the purpose and application of the Indemnity Agreement, and also confirmed its enforceability. It also confirmed that the terms of the amended Indemnity Agreement, including the CBGL guarantee, cannot be amended in any way or in any circumstance (including were CBG to sell CISGIL to a third party) without the written agreement of all parties to the agreement (i.e. RLCIS, CISGIL and CBGL).
- 3.65 Several other agreements were made with effect from 15 January 2006, between RLCIS, CISGIL, CBGL (under its previous name of Co-operative Financial Services Limited) and CFSMSL which among other things facilitated the Indemnity Agreement. I have set out these agreements schematically in Appendix F.

#### Other intra-group relationships

- 3.66 CISGIL currently has the following relations with other parts of the Co-operative Group:
- All banking is with the Co-operative Bank.
  - Expenses attributable to CBGL subsidiaries are borne by CFSMSL (a non-regulated entity) and recharged to the appropriate subsidiary (this also covers the purchase of fixed assets).
  - Co-operative Legal Services Limited provides legal services to support legal expenses and other general insurance policies.

These services apply in relation to the business written by CISGIL and to that general insurance and reinsurance business written by RLCIS and covered by the Indemnity Agreement.

#### GOVERNANCE – TCF

- 3.67 CISGIL has issued written guidance to its claims teams emphasising the need to adhere to the TCF principles and providing instruction on how this should be achieved in the following areas:
- Providing customers with reasonable guidance on making claims,
  - Responding promptly to claim notifications;
  - Determining claims as soon as is practicable following notification;
  - Ensuring that the burden of proof placed on claiming customers does not act as a deterrent to genuine claims;
  - Keeping customers reasonably informed of the progress of their claims, including responding promptly to reasonable requests for further information;
  - Not rejecting or refusing unreasonably any claim;

- Settling all claims promptly once the customer's claim has been accepted by the insurer and the customer has accepted the offer;
- Making, and retaining for a reasonable period, records of all claims made; and
- Ensuring that other processes such as cancellations and complaints handling are organised in a way that customers are treated fairly.

3.68 I have been told that the RLCIS Operating Committee receives a report at each of its monthly meetings on the business's performance against the FCA's TCF Outcomes in respect of its Life and Savings business. Each report generally takes the form of an executive summary, focusing on issues which had surfaced, or in respect of which there had been some significant change, since the previous report. This would be supported by a more detailed paper setting out the position on all known issues.

3.69 With the increasing importance being attached by the FSA (as it then was) to its Conduct Risk agenda, the TCF reports began, towards the end 2012, also to feature a current assessment of the business's conduct risks.

3.70 An additional regular report, to the Operating Committee and the RLCIS With-Profits Committee, covers any significant TCF considerations and/or issues specific to with-profits business.

3.71 In respect of general insurance business, up until the end of June 2012, a TCF report was produced monthly and presented, at dedicated approval meetings, to a minimum of two members of the General Insurance Executive who had responsibility for the Profit & Loss account. Thereafter, the governance process was amended so that now the TCF reports are approved, by the end-to-end Leadership Team, during monthly meetings of the GI Risk Management Committee.

3.72 The general insurance TCF report takes the form of an executive summary which provides a "Red/Amber/Green" assessment against the target TCF Outcomes, with a period-on-period trend indicator. It also highlights significant issues which have been identified since the previous report, provides an update on previously reported significant issues, and includes details of areas under review or consideration.

3.73 I have seen an example (as at December 2012) of the spreadsheet that is used as a TCF dashboard for the general insurance business. It considers and monitors performance by product line against a large number of criteria, and scores each of those on a monthly basis. Depending on the targets and the degree of tolerance, those scores are then coloured Green, Amber or Red (Green being satisfactory, Red unsatisfactory). Scores are then aggregated by objective and by line of business, with trends noted. The December 2012 example showed scores that were mostly Green, with some Amber and some Red (mostly regarding transparency of information and fulfilment of customer expectations). The dashboard also identifies general issues and discusses actions being taken. I have not audited the accuracy or appropriateness of the various ratings within the dashboard. The TCF dashboard does not differentiate between RLCIS and CISGIL policies.

## 4. THE PROPOSED SCHEMES

- 4.1 In this Section of the Report, I describe the Scheme. I do not describe separately the Jersey Scheme as it is very similar to the Scheme save that the transferring business is just the RLCIS Jersey Business, not all of the general insurance and reinsurance business underwritten by RLCIS, and that the Jersey Scheme is conditional on the Scheme being effective.

### MOTIVATION FOR THE SCHEME

- 4.2 RLCIS was formerly a full-scale composite insurer. In January 2006, CISGIL was created to enable the separation within CBG of general insurance and reinsurance from long-term business. All general insurance and reinsurance business written since then within CBG (including renewals of pre-existing policies) has been written by CISGIL. However, the liabilities arising from general insurance and reinsurance written prior to CISGIL's establishment remained with RLCIS but the economic risk was transferred to CISGIL by means of the Indemnity Agreement.
- 4.3 Initial motivation for the Scheme was "good housekeeping", to complete the separation by legal entity of general insurance and reinsurance from long-term business. This would have had various administrative benefits for CBG.
- 4.4 Since the start of preparatory work related to the Scheme, CBGL has sold RLCIS to Royal London. I have been told that Royal London is fully supportive of the Scheme to transfer the general insurance and reinsurance liabilities from RLCIS to CISGIL.

### SCHEME OUTLINE

- 4.5 Under the Scheme, the business to be transferred comprises all of the general insurance and reinsurance business underwritten by RLCIS ("the Transferring Business"). All liabilities in respect of the Transferring Business, and all residual assets not already passed to CISGIL under the Indemnity Agreement (which comprise the applicable reinsurance protections and the right to future premiums), will be transferred on the Effective Date. All future income and outgoings arising from the Transferring Business will pertain to CISGIL. Existing policyholders of RLCIS in respect of the Transferring Business will become policyholders of CISGIL.
- 4.6 Table 4.1 below show simplified balance sheets for CISGIL pre and post the Scheme (based on the FSA Returns for CISGIL as at 31 December 2012).

**Table 4.1**  
**Simplified Balance Sheets for CISGIL**  
**as at 31 December 2012**

	Pre-transfers (£ million)	Post-transfers (£ million)
<b>Assets</b>		
Investments	1,137.5	1,137.5
Reinsurers' share of technical provisions	44.8	66.6
Debtors and salvage	198.6	198.6
Other assets	49.7	49.7
Inadmissible assets	6.2	6.2
	1,436.9	1,458.7
<b>Liabilities</b>		
Capital and reserves	276.1	276.1
Loan capital	85.0	85.0
Gross technical provisions	1,058.2	1,080.0
Creditors	47.0	47.0
Other liabilities	-29.5	-29.5
	1,436.9	1,458.7

- 4.7 As shown in Table 4.1, although the liabilities to be transferred from RLCIS to CISGIL have already been effectively assumed by CISGIL under the Indemnity Agreement, they are included as part of the gross technical provisions within the balance sheet as at 31 December 2012 net of RLCIS's outwards reinsurance programme. The effect of the transfer upon the balance sheet will be to add the expected recoveries to the reinsurers' share of the technical provisions (as the stated beneficiary under RLCIS's outwards reinsurance programme will become CISGIL rather than RLCIS as a result of the Scheme) while increasing the gross technical provisions by an equal amount. If, after the Effective Date, there remain within RLCIS any Excluded Policies then, as discussed in paragraph 3.62 above, it is intended that the Indemnity Agreement would remain in place.
- 4.8 Tables 4.2 and 4.3 below show simplified balance sheets for RLCIS pre and post the Scheme (based on the FSA Returns for RLCIS as at 31 December 2012), separately for the long-term insurance business and for the other than long-term insurance business.

**Table 4.2**  
**Simplified Balance Sheets for RLCIS (long-term insurance business only)**  
**as at 31 December 2012**

	Pre-transfers (£ million)	Post-transfers (£ million)
<b>Assets</b>		
Investments	19,898.9	19,898.9
Reinsurers' share of technical provisions	3,598.4	3,598.4
Debtors	10.2	10.2
Other assets	178.6	178.6
Inadmissible and other assets	34.5	34.5
	23,720.7	23,720.7
<b>Liabilities</b>		
Capital and reserves	1,240.0	1,240.0
Loan capital	0.0	0.0
Mathematical reserves (gross)	16,180.4	16,180.4
Other insurance/non-insurance liabilities	4,084.1	4,084.1
Other adjustments to liabilities	2,216.3	2,216.3
	23,720.7	23,720.7

**Table 4.3**  
**Simplified Balance Sheets for RLCIS (other than long-term insurance business only)**  
**as at 31 December 2012**

	Pre-transfers (£ million)	Post-transfers (£ million)
<b>Assets</b>		
Investments	238.3	238.3
Reinsurers' share of technical provisions	21.8	0.0
Benefit of the Indemnity Agreement	64.8	0.3
Debtors and salvage	0.0	0.0
Other assets	0.3	0.3
Inadmissible assets	0.3	0.3
	325.5	239.2
<b>Liabilities</b>		
Capital and reserves	244.2	244.2
Gross technical provisions	86.6	0.3
Creditors	0.0	0.0
Other liabilities	-5.4	-5.4
	325.5	239.2

- 4.9 As shown in Table 4.2, the transfer has no effect on the RLCIS balance sheet in respect of the long-term business. However, as shown in Table 4.3, the transfer removes an equal amount from both the assets and liabilities, through the transfer to CISGIL of the liability for the Transferring Business and of the reinsurers' share of that part of the technical provision, and through the reduction to zero of the benefits provided under the Indemnity Agreement in respect of the Transferring Business.
- 4.10 There is also a small adjustment due to the transfer of RLCIS's exposure to asbestos claims relating to the electricity industry. In accordance with PRA guidance, the gross technical provisions for these claims are included within the FSA returns on an undiscounted basis and the discount is then included as a reconciling item (in Table 4.3 it is included as a negative amount within Other Liabilities, with an equal amount within Inadmissible Assets).
- 4.11 Table 4.3 assumes that some Excluded Policies (with gross liability totalling £0.3m) will remain within RLCIS after the Effective Date. These are the 11 remaining non-EEA inwards reinsurance policies. No outstanding claims within RLCIS relate to policies written under laws other than the EEA. It is possible that a proportion of the reserves held in respect of claims that have yet to be reported would be in respect of direct Excluded Policies but that proportion would be very small. On the basis of the gross reserves as at 31 December 2012 in respect of the non-EEA inwards reinsurance policies I have included £0.3m as both the post-transfer Technical Provisions and the post-transfer Benefit of the Indemnity Agreement in Table 4.3 above. I note that in-principle agreement has been reached with the cedants of some of these non-EEA inwards reinsurance policies for them to be novated ahead of the Effective Date and that discussions are underway regarding the possible novation of the other non-EEA inwards reinsurance policies. Hence, it is likely that the residual gross technical provisions relating to business other than long-term that remain within RLCIS post the Effective Date of the Scheme will be less than the £0.3m indicated in Table 4.3 above, and might be zero.
- 4.12 I have been told by CBG that no capital will be moved from RLCIS to CISGIL as a result of the Scheme.
- 4.13 Post the proposed transfer, the administration and management of the Transferring Business will be undertaken by CISGIL in the same manner as currently.
- 4.14 No compensation will be paid to CISGIL in consideration of the transfer of the Transferring Business to CISGIL, although CISGIL will assume directly the insurance liabilities in respect of the Transferring Business.
- 4.15 Nothing in the Report should be regarded as providing a legal opinion on the effectiveness of the Scheme.
- 4.16 I have not considered any alternative schemes.
- 4.17 The Effective Date of the Scheme is expected to be 31 March 2014.

## POLICYHOLDERS AFFECTED

- 4.18 I have considered the effects of the Scheme on three main groups of policyholders, namely:
- those policyholders of RLCIS whose policies are to be transferred;
  - the current policyholders of RLCIS who have policies that are not being transferred (these are mainly the holders of life policies but would also include the holders of Excluded Policies, if any); and
  - the current policyholders of CISGIL.
- After the Scheme is sanctioned it is intended that there will be no general insurance or inwards reinsurance policyholders remaining in RLCIS; only the life policyholders will remain. However, as noted in paragraph 3.25 above, it is possible that some Excluded Policies will also remain within RLCIS after the Effective Date.
- 4.19 I do not consider that the policyholders of any other insurance companies are affected by the Scheme.

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## COMPENSATION AND COMPLAINTS

- 4.20 After the implementation of the Scheme, as with all other insurance companies with an establishment in the UK, CISGIL will be required to participate in the FSCS, as it has done since its inception. The Scheme will have no impact on the eligibility of any policyholder or group of policyholders for compensation under the FSCS.
- 4.21 The Scheme will have no effect on the eligibility of any policyholder or group of policyholders to bring complaints to the UK FOS. If, as described in Section 2, they are currently able to bring complaints to the FOS, then this will remain the case after the implementation of the scheme. If they are currently not eligible to complain to the FOS then this will also remain the case after the implementation of the scheme.

## ADMINISTRATION

- 4.22 After implementation of the Scheme, the current businesses of RLCIS and CISGIL will continue to operate as they currently do, i.e. the general insurance and reinsurance business of each entity will continue to be managed and administered as presently by or on behalf of CISGIL, and the long-term business of RLCIS will continue to be managed and administered by RLCIS. As regards the general insurance and reinsurance business, the management and administration includes underwriting (for CISGIL – there is no longer any underwriting for RLCIS), claims, operations, risk management and systems.
- 4.23 As noted in Section 2, there is an FCA requirement that companies treat customers fairly in all their actions. These requirements will still apply to policyholders in CISGIL after the proposed transfer.
- 4.24 The CISGIL approach to TCF is outlined in Section 3 above and is applied equally to policies underwritten by CISGIL and to those underwritten by RLCIS. I have no reason to believe that implementing the Scheme will affect the way in which the claims are currently being handled, and the management of CISGIL has assured me that there will be no change.

## EXCLUDED POLICIES

- 4.25 As discussed in paragraph 3.25 above, any policies which, while capable of being transferred from an English or Jersey law perspective, are governed by law which might not recognise the Orders of the Court or the Jersey Court effecting the transfer, will be treated as Excluded Policies. While the gross liability for these policies would remain with RLCIS, the economic value of these policies would remain transferred to CISGIL under the amended and restated Indemnity Agreement. I understand that, post the Effective Date of the Scheme, RLCIS and CISGIL will continue to investigate the possibility of novation from RLCIS to CISGIL, or (if appropriate) commutation, of each and every policy that has been identified as potentially being among the Excluded Policies.

## STRUCTURE AFTER THE SCHEME

- 4.26 CISGIL and RLCIS will both remain in existence after the Scheme has been implemented, CISGIL as a general insurance and reinsurance operation and RLCIS as a life assurer (albeit with possibly a small amount of general insurance and reinsurance liabilities in run-off, these comprising any Excluded Policies remaining within RLCIS). This would not be affected by any changes subsequent to the date of the Report in the ownership of CISGIL.

## CAPITAL POLICY AFTER THE SCHEME

- 4.27 The capital policy of CISGIL is not formally documented, although CISGIL has documented its Risk Appetite Policy which would be a key component of any capital policy. I have been told that the capital policy of CISGIL will not be impacted by the Scheme. CISGIL will continue to maintain capital for the entirety of its business to support its ICA risk based capital assessments.
- 4.28 Capital in CISGIL is currently maintained using a risk based approach in line with the ICA, as set out in Section 2, such that the company has a low likelihood of falling below regulatory required capital or of making an operating loss (excluding significant expenses) in any one year (as set out in paragraph 3.57 above).

- 4.29 The capital policy set out above will be replaced by a suitable alternative following the implementation of Solvency II. The implementation of Solvency II is considered unlikely to occur before 2016.

## APPROACH TO COMMUNICATION WITH POLICYHOLDERS

- 4.30 RLCIS and CISGIL have set out the approach they intend to take in communicating information about the proposed transfer of business to the affected policyholders and other parties.

- 4.31 The main objectives of the communications are to:

- Give affected policyholders the information that they need to understand the proposed changes;
- Inform affected policyholders about the implications for them of the proposed changes;
- Give affected policyholders access to further relevant information (beyond that in the communications pack);
- Let affected policyholders know what steps they should take if they object to any of the proposed changes;
- Maintain customers' confidence in CISGIL's willingness and ability to continue to meet their obligations under transferring and non-transferring policies; and
- Meet legal and regulatory requirements.

- 4.32 CISGIL and RLCIS propose the following contact with policyholders/potential claimants and third parties:

- Letters to
  - RLCIS policyholders with general insurance or reinsurance claims outstanding as at the date of the directions hearing (a letter would also be sent to any RLCIS policyholders who reported general insurance or reinsurance claims subsequent to that date, as soon as possible after the claim had been reported);
  - Inwards reinsurance cedants (or broker intermediaries if appropriate) relating to those inwards reinsurance contracts for which RLCIS continues to carry gross reserves in respect of potential claims;
  - Brokers of the outwards reinsurance contracts that relate to the business for which RLCIS continues to carry gross reserves (the communication would include a matrix of reinsurers for them to contact);
  - Managers of insurance pooling arrangements, to the extent that there are any outstanding claims in respect of those arrangements;
  - Recipients of payments under Periodical Payment Orders ("PPOs").

The letters to the RLCS policyholders with general insurance or reinsurance claims outstanding as at the date of the directions hearing and to the recipients of payments under PPOs will include a policyholder guide with the following content: Introduction, Contents, Q&A, Scheme Summary, Summary of the Independent Expert's Report, and Legal Notices. The letters to the inwards reinsurance cedants, to the brokers of outwards reinsurance arrangements and to the managers of insurance pooling arrangements will include a summary of the Scheme and of the Independent Expert's Report;

- Notices in the London, Edinburgh, Belfast and Jersey Gazettes;
- Advertisements in a selection of newspapers.

The letters, notices and advertisements will refer all queries to a postal address or a telephone number or a website address, all of which will be dedicated to responding promptly to any such queries.

- 4.33 Aside from its outstanding general insurance and reinsurance claimants, RLCIS does not intend notifying directly any of its policyholders (whether holders of general insurance or reinsurance policies, or life policyholders) of the proposed transfer. Similarly, CISGIL does not intend notifying directly any of its existing policyholders of the proposed transfer.

- 4.34 The communications are directed at the holders of RLCIS general insurance and reinsurance policies as they will be directly affected by the Schemes. RLCIS life policies are not to be included within the Schemes.
- 4.35 The overall approach proposed by CISGIL and RLCIS to communication with policyholders has been constructed to be proportionate to the expected impact of the relevant Schemes on affected policyholders.
- 4.36 The companies do not intend to send the communication pack to, or otherwise notify, any new customers who take out a policy with CISGIL between the date of the first Court hearing and the date of implementation.
- 4.37 I comment on this proposed approach to communications with policyholders in Section 9.

## 5. GENERAL CONSIDERATIONS OF THE INDEPENDENT EXPERT AND THE INDEPENDENT ACTUARY

### THE INDEPENDENT EXPERT

#### Introduction

- 5.1 I have compiled my report in accordance with Chapter 18 of the Supervision Manual of the PRA Handbook.
- 5.2 Under FSMA, the concept of TCF should be applied. To help ensure that customers are treated fairly in the future it is necessary to understand how they have been treated in the past. From the policyholders' perspective, the acceptability of the Scheme must be on the basis that it will not have a materially adverse effect on their benefits or fair treatment.
- 5.3 I need to consider the terms of the Scheme generally and how the different groups of policyholders are likely to be affected by the Scheme and, in particular:
- The effect of the Scheme on the security of the policyholders' contractual rights, including the likelihood and potential effects of the insolvency of the insurer; and
  - The likely effects of the Scheme on policyholder servicing levels (e.g. claims handling).
- 5.4 The main factors that determine the risks to which a policyholder is exposed are:
- Size of company;
  - Amount of capital held, other calls on that capital and capital support currently available to the company;
  - Reserve strength;
  - Investment strategy;
  - Mix of business written; and
  - Company strategy – for example, whether it is open or closed to new business.

#### Security of Policyholder Benefits

- 5.5 As part of my role as Independent Expert for this scheme, I need to consider the security of policyholder benefits, i.e. the likelihood that policyholders will receive their benefits when due.
- 5.6 In considering and commenting upon policyholder security I shall consider the financial strength of each entity. Financial strength is provided by the margins for prudence in the assumptions used to calculate the Technical Provisions, by the shareholder capital and by any specific arrangements for the provision of financial support. In considering policyholder security it is also necessary to take into account the potential variability of future experience (including claim frequency and severity). Security is also affected by the nature and volume of future new business.
- 5.7 The nature of the assets that constitute each company's capital and surplus is also relevant. The shareholder is able to withdraw surplus shareholder assets (i.e. retained profits, but not share capital, or, in the case of RLCIS, monies within the long-term fund other than in accordance with the Principles and Practice of Fund Management ("PPFM") for the Long-Term Fund) in the form of realised profits, provided minimum capital requirements are met. The security provided by such assets may therefore be temporary.

- 5.8 After the Effective Date, the general insurance and reinsurance policyholders of RLCIS (other than those holders of Excluded Policies) will hold insurance policies with CISGIL (and the life policyholders of RLCIS will remain with RLCIS). Nonetheless, because of the operation of the Indemnity Agreement between CISGIL and RLCIS prior to the Effective Date and because any Excluded Policies after the Effective Date remaining within RLCIS will be subject to the continuing Indemnity Agreement between CISGIL and RLCIS, at a CBG level (or at the level of the acquiring company were CISGIL to be sold prior to the Effective Date of the Scheme) there is no change in the overall risk. Nevertheless, in considering the consequences of the Scheme for policyholder security, I do not consider it appropriate to place reliance on the prospect of significant voluntary shareholder support in adverse conditions.

#### Effect on Members

- 5.9 As an industrial and provident society, CISGIL is considered to be a mutual company as regards SUP 18. SUP 18.2.38 requires that I describe the effect of the Scheme on the proprietary rights of the members of the CISGIL, including the significance of any loss or dilution of the rights of those members to secure or prevent further changes which could affect their entitlements as policyholders. I should also consider and comment on the appropriateness of any compensation paid under the Scheme to members for any diminution of proprietary rights.
- 5.10 For this Scheme, the situation is simplified in that the members who own CISGIL are themselves other entities within the Co-operative Group, not the policyholders *per se*. As such, the Scheme has no effect on the proprietary rights of the members who own CISGIL, and no compensation will be paid. It is my opinion that this is appropriate and I consider no further analysis of this issue to be necessary.

#### Treating Customers Fairly

- 5.11 As Independent Expert for the Scheme I need also to consider the proposals in the context of the FCA's TCF regime and, in particular, the impact of the proposals on the benefit expectations of policyholders.
- 5.12 This involves consideration of areas where discretion is involved on behalf of the relevant insurance company with regard to charges applied to a policy and the benefits granted to the policyholder, and also to service standards applied.

#### Other Considerations

- 5.13 SUP 18.2.36 requires me, as Independent Expert, to consider the likely effects of the Scheme on matters such as investment management, new business, administration, expense levels and valuation bases insofar as they might impact on levels of service to policyholders or on the security of policyholders' contractual rights.
- 5.14 I am also required to consider the cost of the Scheme and the tax effects of the Scheme insofar as they might impact on the security of policyholders' contractual rights.

#### THE INDEPENDENT ACTUARY

- 5.15 In fulfilling my role as Independent Actuary for the Jersey Scheme, I have applied the same considerations to the Jersey business and policyholders of RLCIS and CISGIL as I have to the overall business and policyholders of RLCIS and CISGIL in my role as Independent Expert for the Scheme.

## 6. THE IMPACT OF THE SCHEMES ON THE TRANSFERRING POLICYHOLDERS OF RLCIS

### INTRODUCTION

- 6.1 Under the Schemes, the general insurance and reinsurance business of RLCIS will be transferred to CISGIL.
- 6.2 The main issues affecting the transferring policyholders of RLCIS as a result of the Schemes are likely to arise from relative differences in:
- The financial strength of CISGIL after the transfer compared with that of RLCIS. Financial strength is derived from:
    - the strength of the reserves held;
    - excess assets or capital; and
    - specific financial support arrangements.
  - The risk exposures in CISGIL compared with those in RLCIS.
  - The policy servicing levels provided by CISGIL after the transfer compared with those currently enjoyed by the policyholders of RLCIS.
- 6.3 In this Section I deal with each of these in turn.

### RESERVING

- 6.4 In practice, CISGIL sets reserves collectively for all of the general insurance and reinsurance business written by CISGIL and by RLCIS. CISGIL separately provides a breakdown to RLCIS of the estimated reserves in respect of RLCIS business only. As discussed below in paragraphs 6.5 to 6.25, I have reviewed the process by which reserves are set by CISGIL (generally), including the reserves for RLCIS. I am unaware of any differentiation in the reserving approach, methodologies or assumptions between those applied to business underwritten by RLCIS and those applied to business underwritten by CISGIL.
- 6.5 I have been provided with details of the reserves as at 31 December 2012 (and also provisional reserve estimates as at 31 March 2013 and as at 30 September 2013, as well as a summary of the booked reserves as at 30 June 2013), the process by which the reserves are established and details of the internal actuarial reviews which have been performed. I have also discussed the processes and key issues arising from the reviews with the relevant actuaries.
- 6.6 I have not attempted to review in detail the calculations performed by the respective actuaries. Instead, I have reviewed the process by which reserves are set, the approach followed by the relevant actuaries, the key areas of reserve uncertainty and the apparent strength of the reserves based on this review.
- 6.7 The internal actuaries have used generally accepted actuarial methods to estimate reserve requirements (termed “best estimate reserves”). The best estimate reserves that underlie the booked reserves as at each quarter-end are based on the best estimate reserves actuarially estimated as at the preceding quarter-end, rolled forward by a quarter (i.e. adjusted for differences between the actual experience over the quarter and that which would have been expected based on the preceding quarter-end’s analysis of reserves). This approach is not unusual and I am satisfied that the methodologies, major assumptions and results as at 31 December 2012 appear reasonable. I discuss in subsequent paragraphs below my views of the methodologies, major assumptions and results as at later dates.
- 6.8 Reserve estimates are always uncertain as they can be affected by decisions, actions and events that are yet to occur. As at 31 December 2012, the CISGIL actuaries have identified several specific sources of uncertainty. As the reserves are dominated by Private Motor business, the most significant sources of uncertainty concern the settlement amounts for large claims, in particular:

- 6.8.1 the discount rate applied when evaluating lump sum payments. This is set from time-to-time by the Lord Chancellor and is intended to reflect real rates of return to be earned on lump sum payments invested in low risk assets. Currently, the rate is set at 2.5% per annum which many commentators regard as high relative to underlying interest rates. A reduction has been anticipated for several years but, as yet, the Lord Chancellor has declined to reduce it. In its reserves, CISGIL assumes a discount rate of 2.25% which is predicated upon the broad assumptions that the discount rate applied to settlements will eventually fall to 2.0% but by that time 50% of affected claims that are currently outstanding will already have been settled;
- 6.8.2 the proportion of large claims settled using PPOs rather than lump sum payments. As reserves for future payments under the former are usually calculated using lower discount rates than those underlying lump sum payments, any increase in the proportion of claims currently outstanding being settled using PPOs would be expected to increase costs to CISGIL and RLCIS. The discounting seen within the gross reserves for both RLCIS and CISGIL is almost entirely attributable to the allowance for PPOs (both those already awarded and those anticipated) within the calculation of the gross outstanding liabilities; and
- 6.8.3 just less than half of the gross discounted reserves in respect of motor business within RLCIS relate to PPOs already awarded. For these, along with the investment risk, RLCIS is carrying longevity risk, i.e. the risk that those awarded the PPOs will survive for longer than assumed within the reserving assumptions.
- 6.9 There is also material uncertainty regarding some aspects of the smaller claims:
- 6.9.1 The paid and incurred development patterns for Third Party Damage claims have been diverging. It is not clear whether this reflects speeding up of claim payments or relative weakening of case estimates, or a combination.
- 6.9.2 The proportion of claims being taken on by the MLT has been increasing rapidly. It is not yet clear how effective this unit will prove to be in correctly identifying and repudiating fraudulent claims.
- 6.9.3 The effects of recent reforms to the claims environment, particularly the MoJ reforms implemented in 2010 and 2013, and the LASPO reforms implemented in 2013<sup>24</sup>, have at best been partially seen in the claims data. Their ultimate impact is not yet clear.
- 6.9.4 The impact, in terms of both indemnity and non-indemnity costs, of outsourcing some claims handling is not yet clear.
- 6.10 The uncertainty has been partially mitigated by the addition as at 31 December 2012 of an explicit management margin of £53.3m (8.3%) to the actuarially calculated best estimate reserves.
- 6.11 There are other sources of uncertainty, for example, the presence of asbestos-related exposures (we understand that business with known asbestos exposure has not been written for several years, and that all new and renewal commercial business is now 100% reinsured to a third party, which negates the possibility of on-going inadvertent exposure, net of reinsurance, to asbestos-related and other latent claim types – however, there remains the possibility of further claims emerging from business written many years ago, i.e. in RLCIS, rather than in CISGIL). In my view, considering the experience to date, such other possible sources of uncertainty do not increase materially the uncertainty in the ultimate gross amount of claims.

### Strength of the reserves

- 6.12 I have been provided with the following three reports which, directly or indirectly, consider the relative strength of CISGIL's best estimate reserves and of the booked reserves:
- A report prepared by KPMG entitled *CIS General Insurance Limited: Independent review of motor portfolio reserves* and dated 29 October 2012 ("the KPMG Motor Report");

<sup>24</sup> The Legal Aid, Sentencing and Punishment of Offenders Act 2012, commonly referred to as LASPO, included an extra part, covering the funding and cost of litigation. Among other features, this outlawed the payment and receipt of referral fees for claims involving personal injury or death.

- A report prepared by PwC entitled External Review of Reserves for Co-Operative Insurance Services General Insurance Limited (“CISGIL”) as at 31 March 2013 and dated 12 June 2013 (“the PwC Reserve Report”); and
  - A report prepared by KPMG entitled *CIS General Insurance Limited: Half-year ended 30 June 2013 Report to the Board* and dated 19 August 2013 (“the KPMG Half-Year Report”).
- 6.13 The KPMG Motor Report resulted from a Risk Mitigation Letter from the FSA, in response to which CISGIL commissioned KPMG to provide an independent review of the reserves for CISGIL’s motor business as at 31 December 2011. As discussed elsewhere in the Report, CISGIL includes within the capital available to meet its ICA and ICG the margin between the claims reserves it holds and its best estimate of the future claim costs. The independent review was, in part, to review CISGIL’s processes whereby it set both the best estimate reserve and the associated margin. As the auditors to CISGIL, KPMG had already performed a high level review of CISGIL’s best estimate reserves as at 31 December 2011 as part of the audit and had stated that, in their opinion, “CISGIL’s best estimate is within a reasonable range of best estimates”. This review of the reserves for CISGIL’s motor business was to be at a more detailed level.
- 6.14 The KPMG Motor Report included a range of best estimates of the unpaid claim amounts as at 31 December 2011, within which lay CISGIL’s best estimate as at the same date, albeit well towards the lower end of the range. It noted the main difference in approach to reserving between CISGIL and KPMG to be greater segmentation of the data by KPMG, which KPMG considered made it easier and quicker to recognise (and respond to) underlying claims trends.
- 6.15 KPMG recommended that CISGIL considered the splitting of claims for reserving purposes:
- By MLT status: the Motor Liaison Team (“MLT”) investigates claims identified as potentially fraudulent. It is likely that the IBNR on such claims would be less than that for a corresponding block of claims not considered as potentially fraudulent;
  - Separately for the indemnity component and non-indemnity component (and Own Legal costs separately from Third Party Legal costs);
  - By “MoJ status”<sup>25</sup>, which would give greater insight into changing number of claimants per claim and the effect that MoJ reforms has on the claims experience;
  - Bodily injury claims by size band;
  - Legal costs by size band of the associated bodily injury claims.
- 6.16 The recommendations were all accepted and implemented by CISGIL, and the revised segmentation underlay its reserve estimates as at 31 December 2012. I note that the change in segmentation resulted in an increase of £55m since the 30 September 2012 reserving exercise in the estimated ultimate cost of claims for accident periods up to 30 September 2012. Had this approach been adopted as at 31 December 2011, it appears likely to me that CISGIL’s estimate of the best estimate reserve for Motor business would, as at the 2011 year-end, have been comfortably above the mid-point of KPMG’s range of reasonable best estimates, all other things being equal.
- 6.17 The PwC Reserve Report was commissioned by CBG in the context of its plan to sell CISGIL. In that report, PwC compared its best estimate of the outstanding liabilities with both CISGIL’s booked and best estimate reserves as at the same date. It noted that CISGIL’s best estimate reserves were 6.5% lower than PwC’s equivalent best estimate, and the reserves that CISGIL was proposing to include within its management accounts, including the management margin, were only 1.1% above PwC’s best estimate.

<sup>25</sup> With effect from 30 April 2010 the Ministry of Justice (“MoJ”) introduced a new process for the handling of undisputed personal injury claims relating to Road Traffic Accidents and of amounts between £1,000 and £10,000. The aim of the new process was to accelerate the settlement process for such claims and to reduce the associated costs involved in reaching settlement. This was to be achieved by making the notification and the entire document transfer activity into purely electronic processes, via an on-line portal operated by the MoJ. Also, associated legal fees would be for fixed amounts. This was to apply to all claims occurring on or after 30 April 2010. “MoJ status” refers to whether or not the claim is proceeding via the portal. With effect from April 2013 these reforms have been extended so that (i) the upper limit for claims to go through the portal has increased from £10,000 to £25,000 and (ii) (subject to certain restrictions) undisputed Employers’ Liability and Public Liability claims of amounts between £1,000 and £25,000 would also be processed via the portal. Collectively, these are often referred to as the “MoJ Reforms”.

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- 6.18 I have discussed the PwC Reserve Report with CISGIL, and have reviewed the papers presented to the Quarterly Reserving Committee as at the ends of the first three quarters of 2013, in order to come to a view as to whether the best estimate reserves estimated by CISGIL as at 31 December 2012, and as at subsequent quarters, were weak and therefore the extent to which the explicit management margin above the best estimate in the reserves booked by CISGIL might not be available to support the ICA and ICG.
- 6.19 As noted in paragraph 6.7 above, CISGIL's best estimate reserves as booked at each quarter-end are based on the results of its reserve analysis as at the preceding quarter-end, rolled forward by 3 months. Therefore, CISGIL's best estimate as at 31 March 2013 had been based on its analysis as at 31 December 2012, rolled forward to the end of March 2013, whereas PwC's best estimate was based on its analysis of the historic data up to 31 March 2013. As a result, PwC's estimates incorporated more recent trends in claims development than did CISGIL's. CISGIL's best estimate of the gross outstanding claim amounts as at 31 March 2013, based on a full analysis of the historic data up to 31 March 2013, was £8 million higher than that resulting from a roll-forward of the reserves calculated as at 31 December 2012 (which had released £4 million). Thus, eliminating the timing difference in the underlying data reduced the difference between CISGIL's best estimate reserves and those of PwC from 6.5% to 5.2%.
- 6.20 The bulk of the difference between CISGIL's best estimate reserves and those of PwC is due to differences between CISGIL and PwC in assumptions regarding future claim development, especially regarding the impact of the MoJ reforms. Some of these differences create surpluses, others shortfalls. I have considered, at a high level, the assumptions underlying the best estimates of PwC and CISGIL as at 31 March 2013 and, despite the sets of assumptions used by both leading to different best estimates, I consider them to be not unreasonable.
- 6.21 PwC said in its report that CISGIL intended, as at 31 March 2013, to reflect the greater uncertainty regarding future claim development caused by the MoJ reforms by increasing the reserve margin in respect of its motor business to a level equal to 9.0% of PwC's best estimate for that business. It would then keep this margin under review, revising it as appropriate to reflect any change in the perceived degree of uncertainty within the best estimate.
- 6.22 The KPMG Half-Year Report summarises work done by KPMG, and the conclusions that it reached, in support of its review opinion on the consolidated accounts of the Co-operative Group as at 30 June 2013. KPMG focused on the reserving process and overall governance, together with an assessment of the significant assumptions using management's sensitivity analysis and/or soft benchmarking. It concluded that it considered "*the booked gross claims reserves (i.e. Best Estimate plus Management Margin) of £651 million to be within an acceptable range*". The KPMG Half-Year Report highlights particular areas within CISGIL's best estimate figures which it considers either prudent or optimistic.
- 6.23 I note that CISGIL's best estimate of the gross outstanding claim amounts as at 30 June 2013, based on a full analysis of the historic data up to 30 June 2013, was £5 million higher than that resulting from a roll-forward of the reserves calculated as at 31 March 2013, the roll-forward having released £6 million.
- 6.24 The best estimate reserves are not deliberately biased upwards or downwards, and do not include any explicit margins. I interpret this measure to be on a basis higher than a 50% confidence level, as the claim distribution is expected to be positively skewed<sup>26</sup>. However, there is, as noted above, much uncertainty as to what assumptions are appropriate and therefore there is a range of values within which a best estimate might be considered reasonable.
- 6.25 The reserves held by CISGIL and RLCIS are based on the actuarial best estimate plus an explicit management margin which is intended to make allowance for various sources of uncertainty surrounding the actuarial best estimate. The booked reserves are also grossed-up to remove any allowance for future salvage and subrogation. The PwC Reserve Report and the KPMG Half-Year Report both considered the booked reserves to be within an acceptable range. I thus consider the reserves held by both CISGIL and RLCIS as at 31 December 2012 and as at subsequent quarter-ends to be at a similar level of strength and both to be on a basis stronger than a 50% confidence level.

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<sup>26</sup> In probability theory and statistics, skewness is a measure of the asymmetry of the probability distribution of a variable. A distribution is skewed if the majority of values lie to one side of the mean. It is positively skewed if the majority of values lie to the left of the mean, i.e. have values lower than the mean, but that there are a few values higher, possibly much higher, than the mean.

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## THE FINANCIAL STRENGTH OF RLCIS

- 6.26 As I have mentioned earlier in the Report, certain capital requirements are private matters between insurers and the PRA and therefore I am not at liberty to disclose in the Report actual figures relating to those requirements, or figures by which those amounts could be calculated. In the Report I have considered the extent to which RLCIS and CISGIL each hold capital in excess of their regulatory solvency level. I refer to the ratio of the actual capital that the entity under consideration holds to the minimum regulatory solvency capital requirement to be the “Capital Cover Ratio”. Each entity will have different Capital Cover Ratios for the different solvency measures. Purely for comparative purposes in the Report I have defined the following terms:
- “sufficiently capitalised” refers to a Capital Cover Ratio between 100% and 119%;
  - “more than sufficiently capitalised” refers to a Capital Cover Ratio between 120% and 149%;
  - “well capitalised” refers to a Capital Cover Ratio between 150% and 199%, and
  - “very well capitalised” refers to a Capital Cover Ratio in excess of 200%.
- 6.27 The general insurance and reinsurance policyholders of RLCIS currently derive their security from the assets supporting RLCIS’s general insurance and reinsurance business and from the capital position of RLCIS. The main asset within RLCIS that supports RLCIS’s general insurance and reinsurance liabilities is the Indemnity Agreement. Therefore, although they have no direct contractual relation with CISGIL, the general insurance and reinsurance policyholders of RLCIS currently derive part of their security indirectly from CISGIL through the Indemnity Agreement. My review of the financial strength of CISGIL is set out below, in paragraph 6.37 onwards. Before reviewing that, I consider below the financial security offered by RLCIS’s capital position.
- 6.28 As at 31 December 2012, RLCIS had undiscounted gross claims reserves of £144.7 million (£86.6 million after discounting), and net claims reserves of nil (as a result of the indemnification by CISGIL). This equates to a gross survival ratio (gross undiscounted reserves at the year-end as a proportion of gross claim payments made in the preceding 12 months) of 7.8 years. This is less than the ratio as at earlier year-ends. However, allowing for the claims paid over the year, RLCIS’s total reserves as at 31 December 2012 are broadly consistent with those held as at 31 December 2011. Of the £86.6 million discounted reserves, £29.3 million relates to 9 PPOs already in payment.
- 6.29 As at 31 December 2012, RLCIS had capital resources available to cover general insurance and reinsurance business capital resource requirements of £38.6 million compared with a MCR of £9.0 million. The capital resources were reduced on completion of the sale and purchase of RLCIS to £11.5 million. In the event that CISGIL were unable to fulfil its responsibilities to RLCIS under the Indemnity Agreement, these assets would be available to meet the obligations to RLCIS policyholders, although, based on RLCIS’s gross reserves as at 31 December 2012 for its general insurance and reinsurance business, they would be far from sufficient to meet all of those obligations. As discussed in paragraphs 3.19 - 3.20 above, in an extreme solvency scenario, claims relating to general insurance and reinsurance could be supported by the General Reserve but only insofar as it then remained available. However, it is also possible that, in the event of an extreme event impacting the solvency of the Long-Term Fund, the Long-Term Fund could likewise seek support from the General Reserve but again only insofar as it then remained available.
- 6.30 I have been told that RLCIS management has established to its satisfaction that the likelihood of the long-term business needing to use the £200 million of General Reserve that has been notionally hypothecated to the long-term business in the Returns to the FSA is remote, other than to provide temporary capital support in particular circumstances, for example, were the PRA not to relax its capital requirements immediately following a significant stress event. I have not seen the analysis supporting this conclusion. This view will be endorsed (or otherwise) by the Court if the General Reserve is required to be transferred to Royal London along with the liabilities and other supporting assets as part of the LTBF Scheme. As discussed in paragraphs 3.22 - 3.23, subject to it maintaining adequate reserves and solvency margins on an on-going basis, RLCIS is under no obligation to maintain the General Reserve at any particular level. I have been told that, post approval and implementation of the LTBF Scheme, Royal London will pay £180 million to CBGL as a deferred consideration under the terms of the SPA, funding that payment by releasing the £200 million of General Reserve.

- 6.31 As discussed in paragraph 3.24 above, Royal London has undertaken to maintain within RLCIS capital at a level at least 110% of that required for RLCIS to meet its minimum regulatory capital requirements in respect of its general insurance and reinsurance business (i.e. it will maintain a Capital Cover Ratio of at least 110% and so would be sufficiently capitalised). Following completion of the sale and purchase of RLCIS, the capital resources (excluding the £200 million of General Reserve) within RLCIS total £11.5 million, which is a Capital Cover Ratio of 128% (based on the MCR as at 31 December 2012). Until implementation of the LTBF Scheme, the £200 million General Reserve would also potentially be available to meet minimum regulatory capital requirements, providing a Capital Cover Ratio of 2,350%. After implementation of the LTBF Scheme, the approval of which would involve PRA and FCA review, the General Reserve will either have been transferred to Royal London or will have been distributed, and will therefore not be available to support the general insurance and reinsurance business (subject to the Court agreeing the validity of the opinion summarised in paragraph 3.22 above).
- 6.32 Although no ICA has been prepared specifically for RLCIS's general insurance and reinsurance business recently, it is apparent that the primary risk exposure for RLCIS's general insurance and reinsurance business is the counterparty risk with CISGIL under the Indemnity Agreement. Given that CISGIL is a UK regulated insurer and should therefore be able to meet its liabilities with a probability of default of no more than 1 in 200 over a one year time horizon for new business (and for the subsequent run-off of the new business written during the one year and for the existing general insurance and reinsurance liabilities), it is reasonable to conclude that the same probability of default should hold for the general insurance and reinsurance policyholders of RLCIS (being entirely reinsured by CISGIL). I also note that, as explained in paragraph 3.62 above, the Deed of Amendment and Restatement adds a guarantee whereby CBGL effectively underwrites CISGIL's obligations to RLCIS under the terms of the amended and restated Indemnity Agreement.

#### Eurozone exposure

- 6.33 Developments in recent years within the Eurozone have resulted in the yields on peripheral European government debt to increase with subsequent falls in value, in particular on Greek bonds and, to a lesser extent, those of Ireland, Italy, Portugal and Spain. Through contagion, this has resulted in difficulties and, in some cases, failure in financial institutions elsewhere in Europe. My concern is whether RLCIS (and CISGIL which I discuss later in this Section) are at risk from the Eurozone problems.
- 6.34 Broadly speaking, RLCIS's general insurance and reinsurance business is not backed by assets with any Eurozone exposures, either direct or indirect, and so therefore should be largely unaffected by any further deterioration in the sovereign debt within those countries (other than by contagion, which would affect the business whether or not the Schemes were implemented). However, it is possible that, were asset values in the long-term fund to fall as a result of further developments in the Eurozone, surplus capital outside the long-term fund would have to be transferred to the long-term fund in order to maintain its solvency margin. I have been told that the Eurozone exposure within the long-term fund is relatively small and therefore it is very unlikely that further deterioration in such assets would directly jeopardise the solvency position of the long-term fund.

#### Conclusion

- 6.35 ***The transferring policyholders of RLCIS under both of the Schemes benefit, indirectly, from the complete indemnification by CISGIL of RLCIS in respect of RLCIS's general insurance and reinsurance business. Therefore, they currently enjoy a very high level of financial security (as a result of the reserve strength and excess assets of CISGIL as described below, plus the obligation of CBGL to make good any failure by CISGIL to fulfil the terms of the amended and restated Indemnity Agreement), as well as having additional financial security from the capital resources within RLCIS that are available to cover general insurance and reinsurance business (although I note that it is intended by RLCIS that a significant portion of the capital resources currently available to the transferring policyholders within RLCIS – the General Reserve – will be distributed as part of, or following, the approval and implementation of the LTBF Scheme).***

## THE FINANCIAL STRENGTH OF CISGIL

- 6.36 As I have explained in paragraph 6.26 above, certain capital requirements are private matters between insurers and the PRA and, as a result, I am restricted as to what I can disclose within the Report relating to those requirements. For example, I cannot disclose the actual Capital Cover Ratios for the ECR, ICA or ICG. Therefore, purely for comparative purposes, I continue to use in the Report the terms “sufficiently capitalised”, “more than sufficiently capitalised”, “well capitalised” and “very well capitalised” in the way that I have defined them in paragraph 6.26 above.

### CISGIL reserve strength pre transfer

- 6.37 As at 31 December 2012, CISGIL held undiscounted gross claims reserves of £751.9 million (gross of handling expenses, net of salvage and subrogation, £694.8 million after discounting), and net claims reserves of £652.3 million. Ignoring that part of the gross claims reserves that relates to RLCIS business covered under the Indemnity Agreement, this equates to a gross survival ratio of 1.5 years. This is a higher ratio than as at 31 December 2011, reflecting the strengthening in the reserves as at 31 December 2012 following the changes in the approach to reserve estimation. The survival ratios vary between classes of business. I am satisfied that the reserves held by CISGIL for these liabilities appear to be reasonable as at the 2012 year end.
- 6.38 As at 31 December 2012, CISGIL reported technical provisions, net of reinsurance, of £1,014.8 million<sup>27</sup> of which the provision for claims outstanding (after discounting and net of reinsurance, salvage and subrogation) amounted to £652.2 million<sup>28</sup>.
- 6.39 The risk profile, as indicated by the classes of business, of the general insurance and reinsurance business within RLCIS and CISGIL is broadly similar. However, the RLCIS general insurance and reinsurance reserves now relate primarily to claims that settle over a long period of time (long-tailed business, claims relating to shorter tailed claims having been settled by now, and also a high proportion of PPOs in payment, which means a higher exposure to mortality risk), the outcomes of which are inherently more uncertain than the outcomes of shorter tailed claims, which comprise a significant proportion of the outstanding liabilities within CISGIL.

### Conclusion

- 6.40 ***Based on my review as described above concerning the reserves of CISGIL as at 31 December 2012, the reserves appear reasonable as at 31 December 2012.***
- 6.41 ***Based on my review of reports presented to the Quarterly Reserving Committee, the proposed reserves in respect of CISGIL's outstanding claims as at 31 March 2013 and 30 June 2013 appear reasonable.***

### CISGIL reserve strength post transfer

- 6.42 Assuming no change in CISGIL's reserving philosophy, the reserves established by CISGIL after the Effective Date will continue to be on a basis stronger than a 50% confidence level, i.e. a continuation of the reserving basis adopted by CISGIL pre transfer under the Schemes.
- 6.43 On the basis that the outwards reinsurance contracts of RLCIS are transferred to CISGIL as part of the Schemes, the net (of reinsurance) reserves of CISGIL post transfer will be unchanged from the pre transfer reserves. I understand that all of RLCIS's outwards reinsurance contracts have been written under English law and therefore I believe that they will be transferred to CISGIL as part of the Schemes.

### Conclusion

- 6.44 ***In practice CISGIL currently sets reserves for the RLCIS general insurance and reinsurance business and will continue to reserve for this business after the proposed transfer on the same basis. As such, having concluded that both RLCIS and CISGIL were reasonably reserved pre transfer, I am satisfied that CISGIL will be reasonably reserved after the Effective Date.***

<sup>27</sup> Based on Form 15, line 19, and Form 13, lines 60 and 61 of CISGIL's Returns to the FSA as at 31 December 2012

<sup>28</sup> Based on Form 15, line 12, less Form 15, line 82, less Form 13, line 61, less Form 13, line 73 of CISGIL's Returns to the FSA as at 31 December 2012

## Excess assets of CISGIL

- 6.45 At a simple level, one measure of capital strength is the ratio of capital to net written premiums. This ratio was 62% using shareholders' funds as at 31 December 2012, which is reasonable when considered alongside the risks facing CISGIL (as discussed in paragraphs 3.49 - 3.54 above).
- 6.46 There are four primary capital measures within CISGIL by which I evaluate the excess assets of CISGIL in the following paragraphs: the MCR; the ECR, the ICA; and the ICG. As described above in paragraphs 6.29 - 6.32, the MCR is also available for the general insurance and reinsurance business of RLCIS and so a direct comparison can be made of the Capital Cover Ratio based on the MCR for the transferring policyholders before and after the Effective Date. However, as explained in Appendix G, the MCR calculation is based upon factors that are not risk-sensitive. Hence, I have also considered the Capital Cover Ratios applying to the transferring policyholders after the Effective Date based on the ECR, the ICA and the ICG, even though I cannot compare them with equivalent measures prior to the Effective Date as no ECR, ICA or ICG is calculated in respect of the general insurance and reinsurance business of RLCIS in isolation. In my opinion, the ECR, the ICA and the ICG better reflect the risks within the business than does the MCR and therefore the Capital Cover Ratios based on the ECR, ICA and ICG provide a more robust indication of the excess assets within the business than does the Capital Cover Ratio based on the MCR.

### MCR

- 6.47 As at 31 December 2012, the policyholders of CISGIL (generally) enjoyed the security of capital resources (i.e. assets available to meet regulatory capital requirements) as measured in CISGIL's 2012 FSA return of £324.0 million compared with a MCR of £205.2 million. The Capital Cover Ratio for the MCR was therefore 158% and the free assets were equal to £118.9 million (i.e. capital resources less MCR). Based solely on the MCR, CISGIL was well capitalised as at 31 December 2012. As noted in paragraph 6.31 above, leaving aside the £200 million of General Reserve notionally hypothecated to the long-term business in the Returns to the FSA, the Capital Cover Ratio for the RLCIS's MCR in respect of its general insurance and reinsurance business was 128%, following completion of the sale and purchase of RLCIS, and, under the terms of the SPA, could reduce further to 110%.

### ECR

- 6.48 On an ECR basis CISGIL was very well capitalised as at 31 December 2012, the ECR being lower than the MCR due to a quirk in the calculation of the MCR, as described in paragraph 3.42 above. I have been provided with information regarding the movement in both the ECR and the available capital during the first nine months of 2013. The ECR has decreased by 9.1% over this period from the value filed with the FSA as at 31 December 2012. Of this reduction, 7.5% is due to a restatement of CISGIL's business plan for 2013, which assumed a reduced volume of premium to be written. Over the same period the available capital has increased by 5%. This implies that CISGIL has continued to be very well capitalised on an ECR basis.
- 6.49 On both the MCR and ECR (free asset and Solvency I cover ratio) measures, the capital resources of CISGIL (generally) are broadly reasonable when considered alongside the risks facing the company.

### ICA

- 6.50 In line with regulatory requirements, CISGIL makes regular Individual Capital Assessments ("ICAs") of the capital it needs to retain in order to maintain its ability to meet its obligations to a level of certainty prescribed by the FSA – the level of capital so determined is intended to ensure that CISGIL is less than 0.5% likely to become insolvent at any time, allowing for one year's new business (or the equivalent percentage over a longer new business period) and the subsequent run-off to extinction of the liabilities.
- 6.51 The ICA is a complicated process that relies on an assessment of the risks in the business, extensive modelling and management judgement to determine an appropriate figure. I have reviewed documents produced by CISGIL detailing its ICA. They describe the work conducted in order to make the assessment, including a discussion of the risks to which CISGIL is subject in the course of its business. I have also reviewed CIS General Insurance Board papers, as at August 2012 and May 2013, both of which document updates to the ICA. Finally, I have discussed with CISGIL management and with members of its capital modelling team the development of the ICA so far over the course of 2013.

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- 6.52 The May 2013 document (which is essentially based on the 2012 year-end position) highlights some of the key sensitivities within the ICA to be:
- Changes in business volumes (for example, a 10% increase in the volume of Motor business written would add £2.9 million to the ICA);
  - Changes investment return (for example, a 10% reduction in the assumed return would add £6.2 million to the ICA);
  - Changes in the pensions deficit (for example, a 10% increase in the costs would add £5.3 million to the ICA);
  - Changes in catastrophe costs (for example, a 10% increase in the costs would add £9.1 million to the ICA);
  - Changes in expected profits (due to changes in attritional claims, large losses, subsidence claims or reserve movement, the effect of which would translate almost directly into the ICA - for example, a £5 million reduction in expected profit would add approximately £5 million to the ICA).
- 6.53 I have considered the appropriateness of the methodology and modelling techniques used. I have also considered the reasonableness of the key assumptions used in the calculations and the results of these calculations. In assessing the reasonableness of the methodology, assumptions and results, I have considered how they compare against my knowledge of the market.
- 6.54 A key set of assumptions employed in deriving the ICA amount are the correlations used for obtaining the diversification benefits between risk categories (i.e. an allowance for the benefit that not all the risks within a risk category will deteriorate at the same time).
- 6.55 The derivation of the various dependency structures involves a large amount of judgement. Based on my high-level review of the various dependency structures, the assumptions adopted by CISGIL for ICA purposes appear broadly reasonable. However, given the level of judgment involved, considerable uncertainties surround the assessment of the diversification benefits utilised in deriving the ICA amount.
- 6.56 I note that the ICA Board papers highlighted areas for enhancing the model underlying the ICA and that, since the May 2013 document, there has been further development of the model. This has involved the transfer of the model to a new platform (Igloo Compact Edition) and various other revisions, the most significant of which has been the addition to the model of various dependencies. CISGIL has now made significant progress in implementing the various capital-related actions recommended by the FSA as part of its August 2011 ICG review letter. Overall, these changes have increased the ICA (as at the 2012 year-end) by 10% over that reviewed by the CIS General Insurance Board in May 2013. I consider the methodology and modelling techniques used by CISGIL to be broadly appropriate and in line with current market practice. The assumptions used within any ICA calculation are a matter of judgement.
- 6.57 The ICA results are disclosed as required to the PRA (and previously to the FSA) but are not made publically available. Therefore, I have not disclosed in the Report the results of any of CISGIL's ICAs. In my view the results provided to me appear reasonable, but I recognise that other results could have been generated using different sets of assumptions that would have been within the bounds of reasonableness.
- 6.58 Nothing emerged from my review of the ICA documents or from my discussions to give me concern as to the financial strength of CISGIL, or for me to conclude that the ICA does not form a reasonable basis for assessing the capital requirements of CISGIL. I have noted that the ICA assumes that reserves are held at best estimate levels. Therefore, both the explicit margin above best estimate within the reserves held as at 31 December 2012 and the claims equalisation reserves may be included within the capital resources available to meet the ICA. Based on the ICA amount that was reviewed by the CIS General Insurance Board on 14 May 2013, increased by 10% as described in paragraph 6.56 above, I consider CISGIL to be more than sufficiently capitalised relative to its ICA. Even were it assumed that there were no margin within the reserves held as at 31 December 2012 (which I would consider to be an overly prudent assumption), CISGIL would still be sufficiently capitalised relative to its ICA.

*ICG*

- 6.59 The FSA provided individual capital guidance (“ICG”) to CISGIL. This guidance set out the results of the FSA’s review of the ICA and the minimum level of capital that it would have expected CISGIL to hold based on its view of the ICA and the risk management framework of CISGIL. The ICG was intended to target the same level of confidence as described above for the ICA, but it represented the FSA’s view rather than that of CISGIL.
- 6.60 Due to limitations on the degree of disclosure permitted by the FSA and now by the PRA, I am not able to provide details of the results of these exercises in the Report. However, based on the figures contained within CISGIL’s Returns to the FSA dated 31 December 2012 and upon the ECR as at 31 December 2012 as submitted to the FSA, I consider CISGIL to be more than sufficiently capitalised relative to its ICG as notified to it in a letter from the FSA dated 8 August 2011. This assumes the inclusion within the capital resources available to meet the ICG of the claims equalisation reserves and the explicit margin above best estimate within the reserves held as at 31 December 2012, and of the difference between the undiscounted and discounted best estimate reserve amount. I consider reasonable the inclusion of these items within the capital resources available to meet the ICG. I have assumed that the tax credit relating to, and partially offsetting, the pension scheme risk cannot be included within the capital resources available to meet the ICG due to the current non-profitability of the Co-operative Group and hence uncertainty as to whether the tax credit would be realisable.
- 6.61 Based on the information with which I have been provided regarding the movement in both the ECR and the available capital during the first nine months of 2013, I consider CISGIL to have continued throughout that period to be more than sufficiently capitalised relative to its ICG. Even were it assumed that there were no margin within the reserves held as at 31 December 2012 or subsequently (which I would consider to be an overly prudent assumption), CISGIL would still have been sufficiently capitalised relative to its ICG throughout the first three quarters of the year.

**Eurozone exposure**

- 6.62 I note that CISGIL has no known exposure, either direct or indirect, to non-UK sovereign debt. Therefore, CISGIL’s general insurance and reinsurance business should be largely unaffected by any further deterioration in the sovereign debt within Eurozone countries (other than by contagion, which would affect the business whether or not the Schemes were implemented).

**Conclusion**

- 6.63 ***Overall, based on my review as described above concerning the excess assets of CISGIL as at 31 December 2012, I believe the policyholders of CISGIL currently enjoy a level of security that is more than sufficient.***

**CISGIL excess assets post transfer**

- 6.64 The excess assets of CISGIL should remain more or less unchanged as a result of the transfer, as all RLCIS business is, in effect, currently reinsured into CISGIL by means of the Indemnity Agreement and no further assets will be transferred from RLCIS, other than outwards reinsurance contracts. In particular, no capital will be transferred from RLCIS to CISGIL as part of the Schemes.
- 6.65 The exception to this is in respect of the assets in excess of the MCR. As noted above in paragraph 6.37, the MCR as at 31 December 2012 is equal to the prior year MCR measure, as it has been since 31 December 2007, and as such is unusually high due to the impact on the MCR as at the 2006 year-end of the implementation of the Indemnity Agreement. However, INSPRU 1.1.69G states that, for the purposes of calculating its MCR, a firm should “*account for contracts of insurance transferred to it from another body as if it had been responsible for those contracts from inception and not merely from the date of transfer. All amounts of premiums and claims that arose from those contracts are included even where they arose prior to the date of transfer and were, in fact, receivable by or payable by the other body.*” Therefore, after the transfer, CISGIL’s MCR will be on a restated basis, even though CISGIL’s liabilities remain unaltered. I have seen calculations of the MCR on this restated basis going back to the 2006 year-end, which indicate that, had the transfer taken place as at 31 December 2012, CISGIL’s MCR post-transfer would have been £105 million (and now lower than the ECR) and the Capital Cover Ratio would have been 310%.

- 6.66 After the proposed transfer is enacted, it is intended that the transferring policyholders of RLCIS will become direct policyholders of CISGIL. These policyholders will continue to benefit from the excess assets after the transfer, as they did as indemnified policyholders before the transfer.

### Conclusion

- 6.67 ***Neither the Scheme nor the Jersey Scheme will have any effect on the excess assets of CISGIL. The policyholders of RLCIS transferring to CISGIL (including those in respect of RLCIS's Jersey Business) will continue to benefit from the excess assets of CISGIL post transfer, as direct policyholders of CISGIL, as they did under the Indemnity Agreement pre transfer.***

### Position of transferring policyholders in the event of the insolvency of CISGIL

- 6.68 We need to consider and contrast the position of transferring policyholders in the event of the insolvency of CISGIL both pre and post transfer.

#### *Pre transfer*

- 6.69 The Deed of Amendment and Restatement binds CBGL to make good any shortfall in the event of CISGIL being unable to meet its obligations to RLCIS under the Indemnity Agreement. I have been told that the net assets of CBGL amounted to over £1 billion as at 31 December 2012. I have not seen a capital assessment relating to CBGL but consider it to be very unlikely that, in the event of CISGIL's insolvency, CBGL would not be able to meet fully CISGIL's obligations under the Indemnity Agreement. Therefore, it is equally unlikely that RLCIS would have to access any of its assets other than the Indemnity Agreement in order to meet fully the claims of its general insurance and reinsurance policyholders. This situation would not be altered were CISGIL to be sold by CBG.
- 6.70 In the very unlikely event that both CISGIL and CBGL did not meet their respective obligations to RLCIS under the amended and restated Indemnity Agreement, RLCIS would have to rely upon available funds within RLCIS to meet (at least part of) the claims of the transferring policyholders. Post completion of the sale and purchase of RLCIS, the capital resources within RLCIS that are available to cover general insurance and reinsurance business capital resource requirements total £11.5m, although, under the SPA, Royal London is only obliged to maintain a Capital Cover Ratio at or above 110%, which, based on the MCR as at 31 December 2012, would be £9.9m. RLCIS would also, if necessary, be able to support the claims of the transferring policyholders from the General Reserve insofar as it remained available. As discussed in paragraph 6.31 above, it is expected that the General Reserve will no longer be available post approval and implementation of the LTBF Scheme.

#### *Post transfer*

- 6.71 Post transfer, transferring policyholders would no longer have access to capital resources within RLCIS and would no longer benefit from the guarantee made by CBGL as part of the Deed of Amendment and Restatement. On the other hand, post transfer the transferring policyholders would rank as creditors alongside the existing CISGIL policyholders and would therefore have less need for funds from outside CISGIL. They would also no longer have exposure, via RLCIS's long-term fund, to further deterioration of sovereign debt in the Eurozone, although as discussed in paragraph 6.34 above I believe the risk of such further deterioration having a material adverse impact upon assets available within RLCIS to meet the (pre transfer) claims of the transferring policyholders to be small.

#### *Comparison of the position pre and post transfer*

- 6.72 In essence, pre transfer, the funds currently within RLCIS and the specific financial support arrangements provided by the Deed of Amendment and Restatement mean that there is negligible risk of transferring policyholders not having their claims met fully in the event of CISGIL becoming insolvent.
- 6.73 Post transfer, in the event of the insolvency of CISGIL, the transferring policyholders would rank alongside the existing CISGIL policyholders and would share with them in the shortfall of assets against liabilities, albeit ranking ahead of some classes of liability.

6.74 Therefore I conclude that, in the event of the insolvency of CISGIL, the transferring policyholders would be disadvantaged by the Schemes. However, because of the current financial strength of CISGIL, I believe that the likelihood of it becoming insolvent in the short term is small. The likelihood of such insolvency increases as the time horizon increases, although similarly over time the liabilities relating to transferring policyholders would decrease as claims are settled and paid out. On that basis, I consider the likelihood of both CISGIL becoming insolvent and the transferring policyholders being materially disadvantaged to be small.

#### Conclusion

6.75 ***In the event that, subsequent to the Effective Date, CISGIL were to become insolvent then, based on the financial position of RLCIS as at 31 December 2012, the Schemes would disadvantage the transferring policyholders of RLCIS. However, taking into account the small probability of CISGIL becoming insolvent in the next few years, I conclude that, overall, the security of the policyholders of RLCIS transferring to CISGIL under the Schemes is not affected to a material extent by the risk of CISGIL becoming insolvent.***

#### Conclusion on the financial strength for policyholders transferring to CISGIL

6.76 ***Based on the reserve strength and capital position of CISGIL, I have concluded that the Scheme will not adversely affect, to any material extent, the security of the policyholders of RLCIS transferring to CISGIL.***

6.77 ***Similarly, I have concluded that the Jersey Scheme will not adversely affect, to any material extent, the security of the policyholders of RLCIS's Jersey Business transferring to CISGIL.***

6.78 I will re-review the financial strength of CISGIL, and the consequences for transferring policyholders, within my supplementary report, to take into account any further financial information that may be available relating to either RLCIS or CISGIL.

#### THE CHANGE IN RISK EXPOSURE DUE TO THE SCHEMES

6.79 The general insurance and reinsurance risk exposures in RLCIS are similar to those within CISGIL, save that the shorter tailed claims have now (almost) all been settled, leaving a rump of longer tailed claims still outstanding – the outstanding direct claims within CISGIL include a higher proportion of shorter tailed claims. However, RLCIS is already exposed to the CISGIL risks through CISGIL's indemnification of RLCIS and therefore, indirectly, the RLCIS general insurance and reinsurance policyholders are also exposed to the CISGIL risks.

#### Conclusion

6.80 ***I am satisfied that neither the Scheme nor the Jersey Scheme will have a materially adverse effect on the security of policyholder benefits through any change of the risk exposures.***

#### THE CHANGE IN POLICY SERVICING DUE TO THE SCHEMES

6.81 The business of CISGIL and RLCIS is currently under the regulatory domain of the PRA and FCA in the UK and, after the Schemes have been enacted, will continue to be so. Further, the transferring policyholders of RLCIS will continue to be protected by the FSCS as summarised in Section 2.

6.82 The business being transferred to CISGIL is already wholly administered within CISGIL and there will be no change to the administration of claims and policies following the Schemes.

#### Conclusion

6.83 ***I believe that neither the Scheme nor the Jersey Scheme will have a materially adverse effect on the policy servicing levels enjoyed by the transferring policyholders of RLCIS compared with their current position.***

#### Conclusion for the policyholders of RLCIS transferring under the Scheme

6.84 ***I am satisfied that the Scheme does not affect in a materially adverse way either the security or the policy servicing levels of the policyholders of RLCIS transferring under the Scheme.***

**Conclusion for the policyholders of RLCIS transferring under the Jersey Scheme**

- 6.85 *I am satisfied that the Jersey Scheme does not affect in a materially adverse way either the security or the policy servicing levels of the policyholders of RLCIS Jersey Business transferring under the Jersey Scheme.*

## 7. THE IMPACT OF THE SCHEMES ON THE POLICYHOLDERS OF RLCIS WHO WILL REMAIN IN PLACE AFTER THE TRANSFER

### Life assurance policyholders

- 7.1 Under the Schemes, it is intended that the general insurance and reinsurance policyholders of RLCIS whom CISGIL currently reinsures will become direct policyholders of CISGIL, and the life assurance policyholders of RLCIS will remain with RLCIS.
- 7.2 The security of the life assurance policyholders within RLCIS is predominantly tied in to the financial strength of the long-term fund. The long-term fund will be unaffected by the Schemes. In addition, the long-term fund can call upon the excess assets from within the shareholders' funds. After implementation of the Schemes, the shareholders' funds within RLCIS will remain the same but the excess assets will increase due to there no longer being any MCR for the transferring business (although RLCIS did not carry any net liability for its general insurance and reinsurance business, the rules regarding the calculation of the MCR restricted the extent to which reinsurance could be taken into account in the solvency margin – post the Effective Date the MCR reduces to zero in respect of the transferring business). There will remain an MCR in respect of Excluded Policies, insofar as any are identified.
- 7.3 Insofar as, post transfer, there are increased excess assets within the shareholders' funds, the financial security of the life assurance policyholders in RLCIS will be enhanced as a result of the Schemes, but this will not be material. There will be no change to risk exposures, policy servicing or administration for the life assurance policyholders in RLCIS as a result of the Schemes.

### Conclusion for the remaining RLCIS life assurance policyholders

- 7.4 ***For the reasons discussed above, I am satisfied that the Schemes will not have a materially adverse effect on the security of the RLCIS life assurance policyholders, including those whose life assurance contracts were written in accordance with RLCIS's Jersey authorisation. Further, the service levels provided to the life assurance policyholders of RLCIS, including those whose life assurance contracts were written in accordance with RLCIS's Jersey authorisation, will not be adversely affected by the Schemes.***

### Holders of Excluded Policies

- 7.5 As described above in paragraph 3.25, it is possible that, after the Effective Date, there might remain in RLCIS some general insurance and / or inwards reinsurance contracts that were not effectively transferred under their own sovereign law by the Schemes and which have not been novated to CISGIL or commuted (the Excluded Policies). The gross liability for these will remain with RLCIS but there will be no net liability within RLCIS as the Excluded Policies will remain covered by the Indemnity Agreement, subject to the Deed of Amendment and Restatement discussed in paragraph 3.62 above. In this respect the situation of the holders of Excluded Policies would be identical to that prior to the Effective Date. There would also be no changes to the policy servicing or administration of the Excluded Policies.
- 7.6 Should CISGIL become insolvent, the policyholders of CISGIL who have outstanding insurance claims would become creditors of CISGIL, as would RLCIS insofar as there were remaining unpaid liabilities under the Indemnity Agreement. However, CISGIL policyholders would rank ahead of RLCIS in recovering unpaid liabilities. In effect, as they are relying upon the Indemnity Agreement for the payment of any insurance claims, pre transfer RLCIS policyholders would rank behind CISGIL policyholders in the event of the insolvency of CISGIL, and post transfer holders of any Excluded Policies would still rank behind CISGIL policyholders, save that the pool of CISGIL policyholders would have been increased by the transferring policyholders.
- 7.7 While this would appear to represent a reduction in the security for the holders of Excluded Policies, the holders of Excluded Policies would still have access to the capital resources within RLCIS that was available to cover general insurance and reinsurance business in the event that claims were not fully covered via the Indemnity Agreement. Moreover, post the Effective Date the transferring policyholders would no longer have any right to call upon the capital resources within RLCIS. In that respect the security for the holders of Excluded Policies would be enhanced by the Schemes.

- 7.8 Moreover, as explained in paragraph 3.62 above, post the sale and purchase of RLCIS, CBGL effectively guarantees the Indemnity Agreement so that then, even in the event of CISGIL's insolvency, holders of the Excluded Policies should have no need to recourse to RLCIS's own funds.

**Conclusion for the holders of Excluded Policies**

- 7.9 ***For the reasons discussed above, I am satisfied that the Scheme will not have a materially adverse effect on the security of the holders of Excluded Policies. Further, the service levels provided to the holders of Excluded Policies will not be adversely affected by the Scheme.***
- 7.10 ***I am similarly satisfied that the Jersey Scheme will not have a materially adverse effect on the security of the holders of Excluded Policies that are part of RLCIS's Jersey Business. Further, the service levels provided to the holders of Excluded Policies that are part of RLCIS's Jersey Business will not be adversely affected by the Jersey Scheme.***

## 8. THE IMPACT OF THE SCHEMES ON THE CURRENT CISGIL POLICYHOLDERS

- 8.1 Under the Scheme and Jersey Scheme, the general insurance and reinsurance policyholders within RLCIS whom CISGIL currently reinsures will become direct policyholders of CISGIL. There will be no transfer of assets from or to CISGIL, other than the outwards reinsurance contracts that relate to the transferring general insurance and reinsurance policies.
- 8.2 The gross discounted liabilities as at 31 December 2012 to be transferred to CISGIL total £86.6 million (this assumes no Excluded Policies remain on the Effective Date). These are significantly smaller than CISGIL's gross technical provisions as at 31 December 2012 of £971.6 million (excluding the RLCIS business under the Indemnity Agreement, and gross of salvage and subrogation), i.e. the RLCIS general insurance and reinsurance business comprises 8.2% of CISGIL's gross discounted liabilities as at 31 December 2012. Net of outwards reinsurance the discounted liabilities as at 31 December 2012 were £865.5m for CISGIL policyholders and £64.8m for the RLCIS general insurance and reinsurance business; the RLCIS general insurance and reinsurance business therefore comprised 7.0% of CISGIL's net discounted liabilities as at 31 December 2012.
- 8.3 Therefore, there will be no change to the reserves, financial strength or risk exposures in CISGIL as a result of the Schemes. No other changes in policy servicing or administration will result from the Schemes.

### Position of current CISGIL policyholders in the event of the insolvency of CISGIL

- 8.4 Pre transfer, should CISGIL become insolvent, RLCIS (if and only if CBGL had not fulfilled its obligations under the Deed of Amendment and Restatement) and the policyholders of CISGIL who have outstanding insurance claims would become creditors of CISGIL. However, as their policies had been written directly by CISGIL, CISGIL policyholders would rank higher than RLCIS in recovering unpaid liabilities. Claims relating to CISGIL policyholders would be first met, to the extent that there were sufficient assets within CISGIL. Only when these liabilities had been met in full, and to the extent that there were remaining assets within CISGIL, would other creditors, including RLCIS, have their claims met. In effect, as they are relying upon the Indemnity Agreement for the payment of any insurance claims, pre transfer RLCIS policyholders would rank behind CISGIL policyholders in the event of the insolvency of CISGIL.
- 8.5 Post transfer, transferring policyholders would be direct policyholders of CISGIL, would no longer be able to benefit from the CBGL guarantee that was put in place by the Deed of Amendment and Restatement, and would rank alongside current CISGIL policyholders who have outstanding insurance claims. In that respect, in the event of CISGIL becoming insolvent, the existing policyholders of CISGIL would be worse-off post transfer than pre transfer. The degree to which they would be worse-off would depend upon the magnitude of the insolvency but broadly speaking they would receive (before any intervention by the FSCS) benefits that would be up to 10.1% less than they would have received in identical circumstances pre transfer.
- 8.6 The liabilities attributable to the Transferring Business are getting ever smaller as the claims run-off. For example, I have been informed by CBG that it expects the liabilities to decline by 65% within 5 years. I consider this to be a reasonable expectation.
- 8.7 The likelihood of CISGIL becoming insolvent in the near future is small (as noted in paragraph 2.26, an insurer that is "sufficiently capitalised" relative to its ICA has a probability of insolvency within the next 12 months of no more than 0.5% - an insurer which, like CISGIL, is "more than sufficiently capitalised" relative to its ICA would have a smaller likelihood of insolvency over the next 12 months); the likelihood of it becoming very insolvent in the near future, resulting in (post transfer compared with pre transfer) a material reduction in benefits for CISGIL policyholders is smaller still. The likelihood of these events occurring increases as the time horizon is extended, but at the same time the materiality of any consequential reduction in benefits for CISGIL policyholders relative to their position had the Schemes not been implemented is declining. I therefore conclude that, in the event of the insolvency of CISGIL, the Schemes disadvantages the existing CISGIL policyholders but not to a material degree.

### Conclusion for the CISGIL policyholders

- 8.8 ***For the reasons discussed above, I am satisfied that neither the Scheme nor the Jersey Scheme will have a materially adverse effect on the security of existing CISGIL policyholders, including those whose contracts were written in accordance with CISGIL's Jersey authorisation. Further, the service levels provided to the policyholders of CISGIL, including those whose contracts were written in accordance with CISGIL's Jersey authorisation, will not be adversely affected by the Scheme or by the Jersey Scheme.***

## 9. OTHER CONSIDERATIONS

### THE LIKELY EFFECTS OF THE SCHEMES UPON REINSURERS OF RLCIS

- 9.1 In accordance with 18.2.33 (11A) of Sup 18, I have considered the likely effects of the Schemes on the reinsurers whose reinsurance contracts are to be transferred by the Schemes from RLCIS to CISGIL.
- 9.2 As noted in paragraph 1.7 above, the run-off of RLCIS's general insurance and reinsurance business is currently handled by CISGIL. This will remain the case post the Effective Date of the Schemes. I have no reason to expect any change in the standards of claims handling or management. Therefore, the magnitude and timing of recoveries claimed against reinsurance contracts relating to the general insurance and reinsurance business be transferred by the Schemes from RLCIS to CISGIL will be unaffected by the Schemes.
- 9.3 Similarly, all matters between RLCIS and the reinsurers whose reinsurance contracts are to be transferred by the Schemes from RLCIS to CISGIL are currently dealt with by CISGIL. This will remain the case post the Effective Date of the Schemes.

### Conclusion for the reinsurers of RLCIS whose contracts of reinsurance are to be transferred by the Schemes

- 9.4 ***For the reasons discussed above, I am satisfied that the Schemes will not have a materially adverse effect on the reinsurers of RLCIS whose contracts of reinsurance are to be transferred by the Schemes.***

### THE APPROACH TO COMMUNICATION WITH POLICYHOLDERS

- 9.5 Regulations made under the FSMA require a communication regarding the proposed transfer to be sent to every policyholder of the parties to the Scheme ("the Parties"). However, consideration may be given to the practicality and costs of sending notices against the likely benefits for policyholders of receiving such communications. In order to comply with SUP 18.2.46G, the companies would be expected to notify the policyholders, or interested persons, at least six weeks before the date of the Court hearing at which the application to sanction the Scheme will be heard.
- 9.6 Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996 require that
- a notice be published in the Jersey Gazette stating that an application for the Jersey Scheme has been made. The notice should also provide the addresses in Jersey of the offices of the Parties at which, for a period of not less than 21 days beginning with the date of the first publication of a notice, copies of the papers presented to the Jersey Court can be inspected; and
  - that a statement be sent to every policyholder of the Parties setting out the terms of the scheme, and containing a summary of the Report sufficient to indicate my opinion on the likely effects of the Jersey Scheme on the policy holders of the Parties.
- 9.7 The Parties' approach to communicating the Schemes to affected policyholders is outlined in Section 4.
- 9.8 CBG has identified nearly 10 million general insurance and reinsurance policyholders within RLCIS who might conceivably be affected by the Scheme, although the likelihood of claims emerging from most of these policyholders is considered to be low by CBG. For example, no explicit IBNR reserve is held in respect of claims of which RLCIS is yet to be notified in respect of its personal lines business (holders of which comprise the bulk of RLCIS's policyholders). There are 1,416 general insurance and reinsurance policyholders within RLCIS who might conceivably be affected by the Jersey Scheme. CBG has also identified 1.7 million policies within CISGIL (993 of which were written under RLCIS's Jersey authorisation), and has told me that roughly 200,000 policyholders are also RLCIS policyholders. The level of data that is held on the policyholders varies by nature of the customer relationship. Given the size and nature of the business of CISGIL, the impact of the Schemes will be minimal both in terms of balance sheet and number of policyholders.
- 9.9 In addition, since the operation of the Indemnity Agreement, RLCIS's general insurance policyholders have been treated as if CISGIL were their insurer.

- 9.10 Measured by gross technical provisions, the portfolio transferring into CISGIL is much smaller than CISGIL's own business.
- 9.11 From a policyholder perspective, Royal London believes that those RLCIS policyholders who are not transferring (they are all life assurance policyholders) will see no change in the way in which they interact with RLCIS.
- 9.12 Accordingly, other than general insurance policyholders of RLCIS who currently have an open claim or claim in payment, the Parties do not intend to notify directly any of the policyholders of RLCIS or CISGIL of the proposed transfer, as it considers that any such direct communication would incur a disproportionate cost relative to the effect of the Schemes on those policyholders.

9.13 The Parties will communicate with RLCIS and CISGIL policyholders as follows:

- Letters to:
  - RLCIS policyholders with general insurance or reinsurance claims outstanding as at the date of the directions hearing (a letter would also be sent to any RLCIS policyholders who reported general insurance or reinsurance claims subsequent to that date, as soon as possible after the claim had been reported);
  - Inwards reinsurance cedants (or broker intermediaries if appropriate) relating to those inwards reinsurance contracts for which RLCIS continues to carry gross reserves in respect of potential claims;
  - Brokers of the outwards reinsurance contracts that relate to the business for which RLCIS continues to carry gross reserves (the communication would include a matrix of reinsurers for them to contact);
  - Managers of insurance pooling arrangements, to the extent that there are any outstanding claims in respect of those arrangements;
  - Recipients of payments under Periodical Payment Orders ("PPOs").
- Indirectly with all other policyholders via notices in the London, Edinburgh, Belfast and Jersey Gazettes, and in a selection of newspapers.

It is intended to support this communication with a "help-line", contactable by post and telephone, which will be dedicated to responding promptly to any queries arising from the communication.

- 9.14 I have reviewed draft copies of the proposed notices and letters, including the draft summary of the Scheme and of the Report. I am not an expert in such communications. However, I consider the draft notices and letters to be clear and concise, and to contain all of the information that I would expect them to contain.
- 9.15 I am satisfied that the proposed approach to communication with policyholders in respect of both Schemes is both proportionate and reasonable.

## SERVICE STANDARDS

- 9.16 Administrative services for CISGIL and the business being transferred to CISGIL are currently undertaken within CISGIL and there will be no change to the administration of claims and policies following the Schemes.
- 9.17 The claims service standards for the business of CISGIL (generally) are required to meet TCF criteria. These arrangements will continue following the implementation of the Schemes.
- 9.18 The Schemes will have no effect on the service standards experienced by existing CISGIL and RLCIS policyholders.
- 9.19 Therefore, I am satisfied that there should be no changes to the service standards for transferring and non-transferring policyholders as a result of the Schemes.

## ASSETS AND LIABILITIES OF RLCIS AND CISGIL

- 9.20 As at 31 December 2012, the gross technical provisions of RLCIS to be transferred to CISGIL under the Schemes amounted to £86.6 million.

- 9.21 As this business is already wholly indemnified by CISGIL no assets will physically transfer from RLCIS to CISGIL, as they already reside within CISGIL under the Indemnity Agreement.
- 9.22 The Court and Jersey Court have the power to order (and the Schemes provides for) the transfer of the relevant outwards reinsurance contracts of RLCIS to CISGIL. On the basis that the relevant outwards reinsurance contracts of RLCIS are transferred as part of the Schemes, the net (of reinsurance) positions of CISGIL should not be adversely impacted as a result of the Schemes.

## OPERATIONAL PLANS AND CHANGES IN ASSETS AND LIABILITIES UP TO THE EFFECTIVE DATE

- 9.23 The balance sheets show amounts as at 31 December 2012. I have chosen this date because it is the latest date for which audited financial information is available.
- 9.24 I expect that the current activities of CISGIL and RLCIS have continued, and will continue, between 31 December 2012 and the Effective Date (and, as appropriate, after the Effective Date). CISGIL has continued, and will continue, to write new business, and has continued, and will continue, to settle claims and reassess reserves in the light of experience for both itself and for RLCIS's general insurance and reinsurance business. I do not consider that any material additional risk to any group of affected policyholders will emerge as a result of the continuation of normal business.
- 9.25 Further to considering the continuation of normal business, I have discussed with CBG and Royal London the possibility of management actions, other than the Schemes, that could affect the financial position of CISGIL and RLCIS (such as significant changes in new business strategy or operational plans).
- 9.25.1 I have already noted that CBG has announced its intention to seek buyers for CISGIL. I have been informed that CISGIL has no planned activities that would have a material effect on the security of its policyholders, either for those that were policyholders as at 31 December 2012 or those that have become policyholders since then. I am unable to comment on whether or not the sale of CISGIL, if and when such an event should occur, would result in a change in CISGIL's operating plans or on the impact of any such changes upon the on-going security of CISGIL's policyholders.
- 9.25.2 I have been informed that it is expected that, for the immediate future, Royal London continues to manage RLCIS in the same way that CBG has been managing it and that the Indemnity Agreement between RLCIS and CISGIL continues to apply, subject to restatement as described in paragraph 3.62 above, at least until such time as all of the general insurance and reinsurance liabilities within RLCIS had been transferred to CISGIL, had been closed or had otherwise been removed from RLCIS's balance sheet.
- 9.25.3 As noted above, I have been told that RLCIS management intends (if permitted) to distribute the £200 million of General Reserve. I also note that, post completion of the sale and purchase of RLCIS, Royal London has agreed that the shareholders' funds available outside the long-term insurance fund will be maintained at a level at least as high as 110% of the MCR (or ECR if higher). I have discussed above the impact of the distribution and of the Royal London undertaking regarding the shareholders' funds upon the security of the benefits relating to both the transferring policies and the Excluded Policies.
- 9.26 I believe that it is unlikely that any events occurring between 31 December 2012 and the Effective Date would affect any conclusion that I have reached based on my review as at 31 December 2012.
- 9.27 A short time before the final Court hearing, I will consider the extent to which actual changes in assets and liabilities have been in line with expectations (relative to the position as at 31 December 2012) and hence whether there have been any changes (including those associated with current economic conditions) that would affect my overall opinion, and, if necessary, I will report on these separately.

## What would happen were the Schemes not to proceed?

- 9.28 I have discussed with CBG management what would happen were the Schemes not to proceed. There are various possibilities, depending on the circumstances.

- 9.29 As has already been stated, the Jersey Scheme is conditional upon the Scheme being effective. Were the Scheme to proceed but the Jersey Scheme were not to proceed, then the RLCIS Jersey Business would be among the Excluded Policies in respect to the Scheme.
- 9.30 If both of the Schemes were not to proceed, Royal London would own an asset (RLCIS) which included gross liabilities relating to general insurance and reinsurance business.
- 9.30.1 Royal London might decide to leave matters as they then remain. Although it would retain a gross liability on RLCIS's balance sheet relating to general insurance and reinsurance business, and would need to maintain shareholders' capital within RLCIS at least equal to 110% of the MCR, the net liability would be zero as the gross liabilities would be fully covered by CISGIL (backed by CBGL) under the restated Indemnity Agreement.
- 9.30.2 As noted above, Royal London intends transferring RLCIS's long-term liabilities from RLCIS to Royal London under the LTBF Scheme. Should the LTBF Scheme go ahead then RLCIS would remain a subsidiary of Royal London but would only contain gross general insurance and reinsurance liabilities, with no long-term liabilities (other than any that could not be transferred as part of the LTBF Scheme ("the LTBF Excluded Policies")) and with nil net general insurance and reinsurance liabilities. The £200 million of General Reserve will either have been deemed to be required by the long-term business and have been transferred to Royal London under the LTBF Scheme or will have been deemed surplus to requirements and (subject to regulatory approval) have been distributed (subject to the Court agreeing the validity of the opinion summarised in paragraph 3.22 above). In such circumstances, Royal London may exercise the option within the SPA that is discussed in paragraph 3.25 above by which CBGL would be required to buy back RLCIS. If and when that sale and purchase were completed, RLCIS would once again be a part of CBG, and would have gross liabilities but nil net liabilities due to the continuing impact of the amended and restated Indemnity Agreement. Alternatively, Royal London might seek a different general insurer to which to transfer the gross general insurance and reinsurance liabilities.
- 9.30.3 I have been informed that the Royal London long-term fund is strong and that management of both CBG and Royal London expect that the LTBF Scheme will proceed. However, I also need to consider what might happen were neither the Scheme nor the LTBF Scheme to proceed. In such circumstances, if Royal London were prepared to continue with the RLCIS long-term business remaining in RLCIS then I believe that its options regarding the general insurance and reinsurance business within RLCIS would be to continue to run it off (as per paragraph 9.30.1 above) or to seek a different general insurer to which to transfer the liabilities. If Royal London did not wish to continue with the RLCIS long-term business remaining in RLCIS then it appears to me that Royal London would have to resell RLCIS.

## SOLVENCY II

- 9.31 As described in Section 2, the regulatory solvency reporting requirements for EU insurers and reinsurers are due to undergo a major overhaul. The date by which the changes for firms will be implemented is uncertain but I understand that it is currently expected to be during 2016.
- 9.32 I am informed that CBG's preparation for Solvency II is currently on schedule. It has recently selected Towers Watson to provide software that will underlie the CISGIL internal model (for Solvency II purposes – to replace its existing internal model which has been used for the ICA). I have seen a schedule of planned activity running from August 2012 showing that, as at the date of the schedule (29 August 2013), no outstanding milestones were overdue. I am further informed that the working assumption within CBG is that it will have just one UK regulated general insurance and reinsurance entity at the time of the internal model approval ("IMA") application (which is scheduled to be by the end of June 2015).
- 9.33 CBG participated in the fifth Quantitative Impact Study ("QIS5") and produced indicative SCR amounts using the standard formula approach, as well as internal model SCR estimates, for CISGIL as at 31 December 2009. This assumed a single entity. No separate work was performed to consider the general insurance and reinsurance business of RLCIS in isolation.

- 9.34 The amounts so calculated indicate that the capital resources as at 31 December 2009 exceed the SCR by a comfortable margin. These amounts have been updated subsequently. The most recent figures that I have seen relate to CISGIL and were as at 30 June 2012. These figures indicated that the capital resources as at 30 June 2012 exceeded the corresponding SCR by a reasonable margin. It should be noted that the standard formula under Solvency II has yet to be finalised, and as such the standard formula figures only illustrate the likely SCR amounts under the new solvency regime.
- 9.35 I have also been informed that Royal London (and RLCIS, in respect of its long-term business) is also well advanced in its preparations for Solvency II. RLCIS's planning for Solvency II has been based upon the assumption that, by the time that Solvency II is introduced, it will retain no gross liability in respect of general insurance and reinsurance business. By the time that Solvency II were implemented, were there to remain within RLCIS any gross liability in respect of general insurance and reinsurance business, then under the terms of the Deed of Amendment and Restatement CISGIL would be obliged to submit to RLCIS records "reflecting information in sufficient detail" to enable RLCIS to complete all reports as required by the regulatory authorities.

### Conclusion

- 9.36 ***I am satisfied that, as neither the Scheme nor the Jersey Scheme alters the overall risk in CISGIL, they will not impact CISGIL's approach to meeting and complying with Solvency II requirements. In addition, based on recent standard formula calculations, CISGIL will have sufficient capital resources to meet its SCR. In my view, the introduction of Solvency II will not impact in a materially adverse way the security and policy serving levels of any group of policyholders affected by either the Scheme or the Jersey Scheme.***

### CBG PENSION SCHEMES

- 9.37 I have been informed that all management, administration, etc. in respect of RLCIS's general insurance and reinsurance business was completely outsourced to CISGIL (and other CBG companies) as part of the Indemnity Agreement, a position reaffirmed by the Deed of Amendment and Restatement. This will continue to be the case post transfer. There are no members of staff who are employed within RLCIS specifically for purposes relating to its general insurance and reinsurance business. Therefore, I do not believe that there will be any staff transfers as a result of the Schemes and hence no pensions or TUPE consequences.

### TAX

- 9.38 I am informed that the Schemes are not expected to have tax implications that would affect any policyholders impacted by the transfer under the Schemes.

### COSTS OF THE SCHEMES

- 9.39 The external costs of the Schemes (estimated to be about £500,000, based on the Schemes and planned communication with policyholders outlined above) will be met by CISGIL. While these costs are not insubstantial, they are one-off in nature and not material in the context of CISGIL's surplus capital as at 31 December 2012 of £93.2 million.

## 10. CONCLUSIONS

- 10.1 In summary, in my opinion, provided the proposed Schemes operate as intended, and I have no grounds for believing that they will not do so:
- The security of benefits of policyholders of RLCIS and CISGIL will not be materially adversely affected by the implementation of the Scheme or of the Jersey Scheme on the Effective Date; and
  - Neither the Scheme nor the Jersey Scheme will have an impact on service standards (operated in accordance with TCF criteria) experienced by the policyholders of RLCIS and CISGIL.
  - The effect of the Jersey Scheme is not to treat policyholders of business written under Jersey authorisation in either RLCIS or CISGIL in a manner which is either more or less favourable than the treatment applied to equivalent policyholders of business written under authorisation other than that of Jersey.
- 10.2 In reaching this opinion I have applied the following principles (as set out in the Transformations TAS):
- I have considered which parties might be affected by the Scheme and by the Jersey Scheme and in what way. I have documented my findings.
  - Although I have not performed my own modelling, rather I have used the results of models developed and operated within CBG, I have reviewed documentation describing the models, describing and justifying the assumptions underlying those models, and explaining the derivation of the data underlying the models and assumptions, in particular explaining how its accuracy, completeness and relevance has been verified.
  - To the best of my knowledge there are no beneficiaries for whom the impact of the Scheme or the Jersey Scheme has not been considered.
  - I have considered how the Scheme or the Jersey Scheme might lead to any changes in the material risks to the benefits of the different interested parties.
  - I have considered the impact on the actuarial information provided to me of CBG having adopted alternative plausible assumptions, for example in the scenario and sensitivity tests within the ICA calculation.

Derek NLC

Derek Newton / 17 December 2013

Fellow of the Institute and Faculty of Actuaries

## APPENDIX A DEFINITIONS

Accident Year	The year to which a claim is allocated based on the date of that accident/claim.
Admissible Assets	Assets valued in accordance with applicable regulations, which can be taken into account for the purposes of demonstrating that insurance companies – or the separate long-term and other-than-long-term funds within insurance companies - meet their solvency requirements.
Correlation	Correlation (in the context of the Report) is a number that describes the statistical relationship between two variables (e.g. equity prices and interest rates).
Enhanced Capital Requirement (“ECR”)	A more risk sensitive capital requirement (than the MCR) for UK insurers as measured by the FSA.
Equalisation Reserve	An equalisation reserve is a reserve built-up (generally from profitable years) as a cushion against periods with worse than average claims experience.
FSA Returns	Accounts, balance sheets, abstracts and statements relating to the business of an insurance company required under FSA rules to be submitted periodically to the FSA. Subsequent to April 2013, companies are required to submit this information to the PRA.
Individual Capital Assessment (“ICA”)	An insurance company’s own assessment of the capital it needs for regulatory purposes in order to mitigate appropriately the risks to which it is exposed and that could otherwise cause it to be unable to meet its liabilities as they fall due.
Individual Capital Guidance (“ICG”)	The FSA’s assessment of the minimum level of capital that it would expect an insurance company to hold based on its view of the insurance company’s ICA and risk management framework.
Minimum Capital Requirement (“MCR”)	Required minimum level of capital under Solvency I rules. See Appendix D for further details.
Reinsurance	An arrangement with another insurer whereby risks are shared (or passed on).
Solvency I	The system for establishing minimum capital requirements for EU insurers under relevant EU Directives presently in-force.
Technical Provisions	Liabilities determined for regulatory purposes. In particular, the provisions for the ultimate costs of settling all claims arising from events which have occurred up to the balance sheet date, including provision for claims incurred but not yet reported, less any amounts paid in respect of these claims; plus the provisions for future claims arising on unexpired periods of risk.

## APPENDIX B TERMS OF REFERENCE

- B.1. The Independent Expert's Report will consider the terms of the Scheme generally and the effect which the Scheme will have on the holders of insurance policies issued by RLCIS and by CISGIL ("the Companies").
- B.2. The Independent Expert's review and Report will address generally the way in which RLCIS and CISGIL have conducted their insurance business, taking into account the particular circumstances of each class of business to be transferred. In summary the review and Report will consider the merits of the Scheme from the perspective of each of the groups of policyholders affected by the Scheme and deemed to require separate consideration. This will involve any policyholders remaining in RLCIS, policyholders being transferred and the existing policyholders of CISGIL.
- B.3. The Independent Expert will carry out the work necessary to enable him to form an opinion on the Scheme. This is likely to include, amongst other things, all or part of the following:
- B.3.1. Production and provision of a data request detailing the information Milliman requires from the Companies in order to provide services under the Scheme.
- B.3.2. Support to the Companies' dialogue with the FSA and provision of information required by that dialogue including:
- information about the Independent Expert, Milliman and its clients in order that the FSA may assess whether it is appropriate for Milliman to carry out this work; and
  - information to enable the FSA to assess whether the proposed Independent Expert is suitably qualified for the role.
- B.3.3. Agreement of the scope of Milliman's work with the FSA, including the provision of the documented agreed scope.
- B.3.4. For each of the Transferor and Transferee, an analysis (where necessary) of the:
- liabilities being transferred (including reserves for incurred but not reported claims, unearned premium reserves and any additional reserve for unexpired risks), including the likely scope for deteriorations in the technical reserves (i.e. the likelihood and extent to which reserves may prove inadequate);
  - assets in respect of outwards reinsurance;
  - bad debt provision in relation to outwards reinsurance;
  - allocation of reinsurance protection to different groups of policyholders, if appropriate;
  - other assets and liabilities to be transferred;
  - current profitability; and
  - exposure to catastrophic losses.
- B.3.5. Comparison of the solvency positions of the Companies, including consideration of any intra group reinsurance contracts and/or guarantees that may be provided, with the aim of comparing the current solvency position with the anticipated solvency position immediately after the Scheme is implemented and after other planned material corporate changes that the Companies have advised to the Independent Expert are completed. The consideration of the solvency position of these companies is expected to be carried out by comparing available capital against regulatory minimum capital based on Solvency I, ICA and the proposed Solvency II (as presently understood) regulations, and taking into account the qualitative and quantitative aspects of these solvency regimes (using, but not limited to, the Companies' internal models for ICA and Solvency II purposes) produced by the Companies for the Transferor and the Transferee (as necessary).
- B.3.6. Analysis of publically available information on the financial strength of each of the Transferors and Transferees, where available, including rating agency reports, analysts' reports annual report and accounts

and financial statements.

- B.3.7. Analysis of the effect of the Scheme on non-financial aspects, including existing policyholder service levels and agreements, for the policyholders remaining in the Transferor (if any), policyholders being transferred and the policyholders of the Transferee.
- B.3.8. Discussion with the Companies regarding the initial findings in respect of the Scheme, which may involve the provision by Milliman of exhibits documenting various findings from its work including where appropriate, but not limited to, work carried out in items D to G above.
- B.3.9. Discussion with the FSA as required, in line with the discussions with the Companies in item H above.
- B.3.10. Production of the Report, for submission to the Court.
- B.3.11. Production or approval of a summary of the Independent Expert Report that forms part of the Scheme summary for inclusion within letters to policyholders.
- B.3.12. Production of the Independent Expert Update Report, for submission to the Court.
- B.3.13. If required attendance at Court hearings. For the avoidance of doubt, Milliman's fee estimates included in this agreement include its attendance at an uncontested Court hearing. Its costs associated with attendance at Court for additional Court hearings or those extended owing to parties contesting the Scheme, and for its preparation time for contested hearings will be charged in addition at Milliman's hourly rates.
- B.4. Milliman will liaise with the Companies and their professional advisors where necessary, in order to complete its work under the Scheme. The Independent Expert will request from the Companies the information required by the Independent Expert which is necessary to complete his work.
- B.5. The scope of Milliman's services and any deliverables will be limited solely to the services and deliverables set out in this agreement. Milliman will make no representation in respect of, and will not consider any other aspect of, the Companies' operations.

These terms of reference were reviewed by the FSA when it approved the appointment of Derek Newton as Independent Expert in respect of the Scheme.

## APPENDIX C CV FOR DEREK NEWTON

- C.1. Derek Newton is a principal and actuarial consultant in Milliman's London office. He is co-leader of Milliman's UK General Insurance practice. He joined the firm in 2003.
- C.2. Since 1994 Derek has worked exclusively within General Insurance, where he has experience with reserving, mergers and acquisitions (M&A) activity, portfolio transfers, Solvency II, the underwriting process, management reporting, designing and evaluating non-traditional risk transfer mechanisms, capital modeling and evaluation, and the design and construction of model office software. His experience includes:
- Providing a full actuarial reserving service to several Lloyd's syndicates. These syndicates were multi-line insurance providers, writing direct and reinsurance covers, covering short-term and long-term, marine and non-marine, property and casualty risks. The service included providing statements of actuarial opinion for Lloyd's and for the relevant US insurance departments, and assisting with the preparation of internal capital assessments, in accordance with the relevant solvency requirements
  - Providing independent assessments of the unpaid claims liabilities of several UK motor insurers
  - Leading assignments to review the underwriting effectiveness of several insurance operations, both commercial and personal lines
  - Leading teams reviewing reserves for two major divisions of a global reinsurer
  - Providing expert-witness support to lawyers involved in legal action concerning insurance companies both in the UK and elsewhere
  - Developing a stochastic model to help a motor insurer evaluate the benefits of a multi-year funding layer as a replacement for more conventional layers of reinsurance cover
  - Leading the development of an innovative strategic planning tool for a UK insurer
  - Leading the review of reserves of various Europe insurers as part of due diligence assignments
  - Providing advice and support to UK insurers preparing for Solvency II
  - Supporting (primarily through peer review) the independent expert in the Part VII transfers of various insurance portfolios.
- C.3. Before joining Milliman, Derek was:
- A director of Heath Lambert's ART division (2002-2003).
  - A partner within Ernst & Young's UK property & casualty consulting practice (1998-2001).
  - In a variety of roles within Prudential plc, culminating in finance director and actuary for Prudential's UK general insurance operation (1983-1998). Prior to 1994, Derek was a Life Actuary, initially within the UK business then latterly as part of Prudential's international division.
- C.4. Derek was awarded Fellowship of the Institute of Actuaries in 1998 and of the Society of Actuaries in Ireland in 2004. He has been a member of the General Insurance Board of the Institute & Faculty of Actuaries since 2002 and chaired the Board 2005-2007. He also served on the Council of the Institute of Actuaries between 2005 and 2010. He has chaired various actuarial working parties and authored or co-authored several papers. He currently chairs the profession's General Insurance Reserving Oversight Committee.

## APPENDIX D KEY SOURCES OF DATA

D.1. In writing the Report, I relied upon the accuracy of certain documents provided by CISGIL. These included, but were not limited to the following:

### Legal documents

- Draft Scheme document and draft Jersey Scheme document
- A copy of the Indemnity Agreement
- An extract from the Sales and Purchase Agreement between CBG and Royal London relating to RLCIS (covering Clause 10.5)
- Deed of Amendment and Restatement in Respect of General Insurance Contracts, between CBGL, RLCIS and CISGIL
- Deed of Indemnity in Respect of the Long-Term Insurance Business of RLCIS, between CBGL, RLCIS and Royal London

### Financial returns and performance

- FSA Returns for CISGIL for the year-ends 2009, 2010, 2011 and 2012, and as at 10 January 2009 (essentially the 2008 year-end – during 2009 CISGIL changed its financial year to match the calendar year).
- FSA Returns for RLCIS for the year-ends 2009, 2010, 2011 and 2012, and as at 10 January 2009 (essentially the 2008 year-end – during 2009 RLCIS changed its financial year to match the calendar year)
- Financial Statements for RLCIS and for CISGIL for the 2011 and 2012 years
- A paper addressed to the CIS General Insurance Board, entitled *Period 7 Financial Performance*, prepared by Finance/Business Oversight and dated 19 August 2013

### Solvency / Capital information

- Documentation of the CISGIL ICA, dated November 2010
- An internal memo dated 11 May 2011 to the CBG Risk Management Committee setting out CISGIL's capital requirements
- A draft of an internal memo updating the CISGIL capital position following the finalisation of the 2012-14 strategic plan, the 2012 budget and the 2011 year-end results
- An extract from a letter dated 8 August 2011 from the FSA to CISGIL providing ICG.
- A paper addressed to the CISGIL Board, entitled CISGIL Year End 2011 ICA, prepared by Charlotte Isherwood and dated 14 August 2012
- Details of the ECR calculation in respect of CISGIL as at 31 December 2012
- Details of the ECR calculation in respect of RLCIS as at 31 December 2012
- A spreadsheet comparing CISGIL's capital requirement according to the ICA with the SCR derived using the Standard Formula and with the SCR derived using the Internal Model, as at 30 June 2012
- A paper addressed to the CISGIL Board, entitled Annual ICAS Update - CISGIL Capital Update 2013, prepared by John Scott and dated 14 May 2013
- A paper entitled CISGIL: Use Test Documentation - Methodology, prepared by Richard Shaw and Esther Prescott and dated 20 August 2013

- A paper entitled CISGIL: Use Test Documentation - Results, prepared by Emma Murch and Esther Prescott and dated 20 August 2013
- A paper (undated, no author noted) entitled Part VII transfer impacts, which sets out the impact of the transfer on the MCR for CISGIL
- A table showing the ECR and ICG amounts for CISGIL as at the month-ends from December 2012 to September 2013 inclusive

## Reserving

- A report prepared by KMPG entitled CIS General Insurance Limited: Independent review of motor portfolio reserves and dated 29 October 2012
- A report prepared by PwC entitled External Review of Reserves for Co-Operative Insurance Services General Insurance Limited ("CISGIL") as at 31 March 2013 and dated 12 June 2013
- Presentation slides dated 23 July 2013 and entitled Management Response to IRR by PwC regarding GI Claims Reserves as at end Q1 2013
- A note from Derek Fuller to the CIS General Insurance Board dated 19 August 2013 and entitled *General Insurance Independent Reserve Review*.
- A report prepared by KMPG entitled CIS General Insurance Limited: Half-year ended 30 June 2013 Report to the Board and dated 19 August 2013 – this report covers more than just reserving
- Actuarial reserve reports prepared by CISGIL as follows:
  - A report (dated 25 October 2013) to the Quarterly Reserving Forum entitled General Insurance Reserving (and P&L Impact on Q3 2013 Results) – I have also received a slide pack (also dated 25 October 2013) which summarises this report;
  - A slide pack entitled Proposed Changes in Reserving Methodology: QRC Phase 2 – Q3 2013, prepared by Kieran Wynne, Kehsey Mok and Daniel Nee, and dated 25 October 2013, together with Minutes of the GI Q3 2013 QRF Phase 2 Meeting of 25 October 2013;
  - A report (dated 17 July 2013) to the Quarterly Reserving Forum entitled General Insurance Reserving (and P&L Impact on Q2 2013 Results) – I have also received a slide pack (also dated 17 July 2013) which summarises this report;
  - A report (dated 30 April 2013) to the Quarterly Reserving Forum entitled General Insurance Reserving (and P&L Impact on Q1 2013 Results);
  - A report (dated 16 January 2013) to the Quarterly Reserving Forum entitled Reserving and P&L Impact on Q4 2012 Results;
  - A report (updated 26 January 2012) to the Quarterly Reserving Forum entitled Reserving and P&L Impact on Q4 2011 Results;
  - A report dated 17 January 2011 to the Quarterly Reserving Forum entitled Reserving and P&L Impact from Q3 2010 Analysis on Q4 2010 Results;
  - Extracts from the December 2010 ARCC reports on general insurance and reinsurance claims and reserving;
  - A report on the CBG general insurance and reinsurance best estimate reserves and adopted margins as at 31 December 2010

### **Inwards reinsurance**

- A list of all RLCIS inwards reinsurance treaties that remained open as at 31 December 2012, and a note that identified which had been commuted by February 2013, and those for which novation had been agreed in principle with the cedant

### **Outwards reinsurance**

- A list of all outwards reinsurance programmes for RLCIS against which there remains an open claim as at 31 December 2012, and policy details of all contracts within those programmes

### **Treating Customers Fairly**

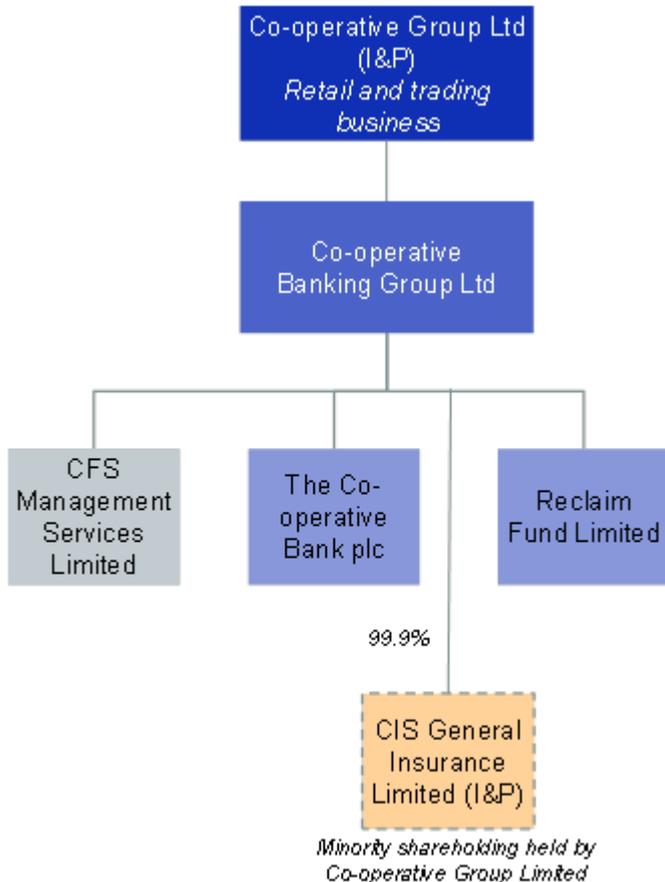
- Internal documents setting out the approach within CISGIL's claims sector to treating customers fairly
- A summary document entitled Evidence of TCF Activity
- A sample spreadsheet entitled GI TCF Dashboard showing data relating to the final month of 2012.

D.2. Information relating to the items listed above was also gathered during discussions with staff of CBG.

## APPENDIX E PICTORIAL SUMMARY OF THE SCHEMES

E.1. The following diagrams sets out schematically the corporate structure of the entities involved in the Schemes and movements that will result from the Schemes.

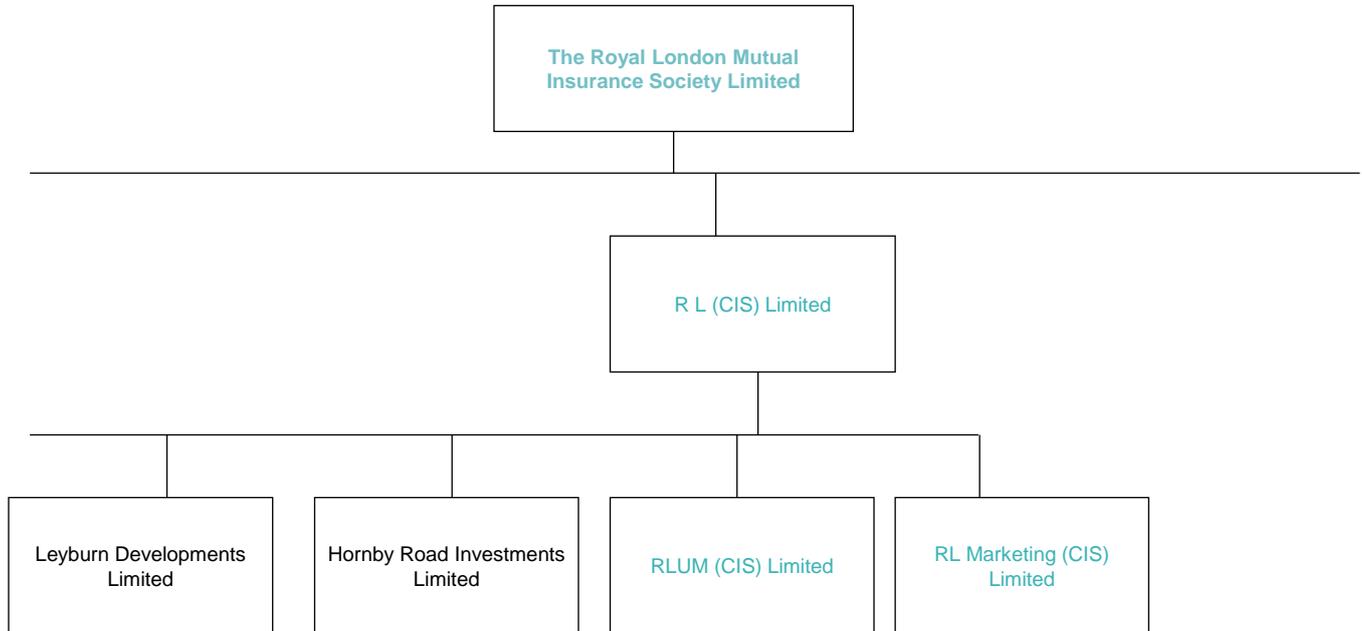
### Extract from the Co-operative Group structure



Note: I&P indicates Industrial and Provident Society  
Includes principal entities only

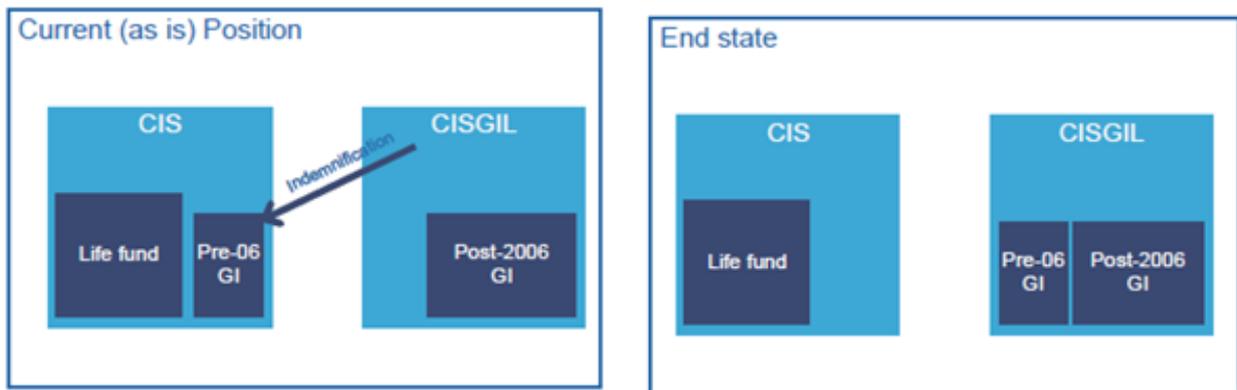
- Co-operative Banking Group Ltd (CBG) is the holding company for a number of regulated financial services entities under the Co-operative Group Limited
- CFS Management Services Limited (CFSMS) - majority of employees within CBG are contracted to CFS Management Services and provide shared services to CBG.
- The Co-operative Bank plc – regulated business unit for retail and corporate banking
- CIS General Insurance Limited (CISGIL) – regulated business unit for general insurance
- Reclaim Fund Limited – this is a not for profit organisation managing dormant saving balances on behalf of the UK Government with any surplus being transferred to the Lottery Fund

Extract from the Royal London group structure



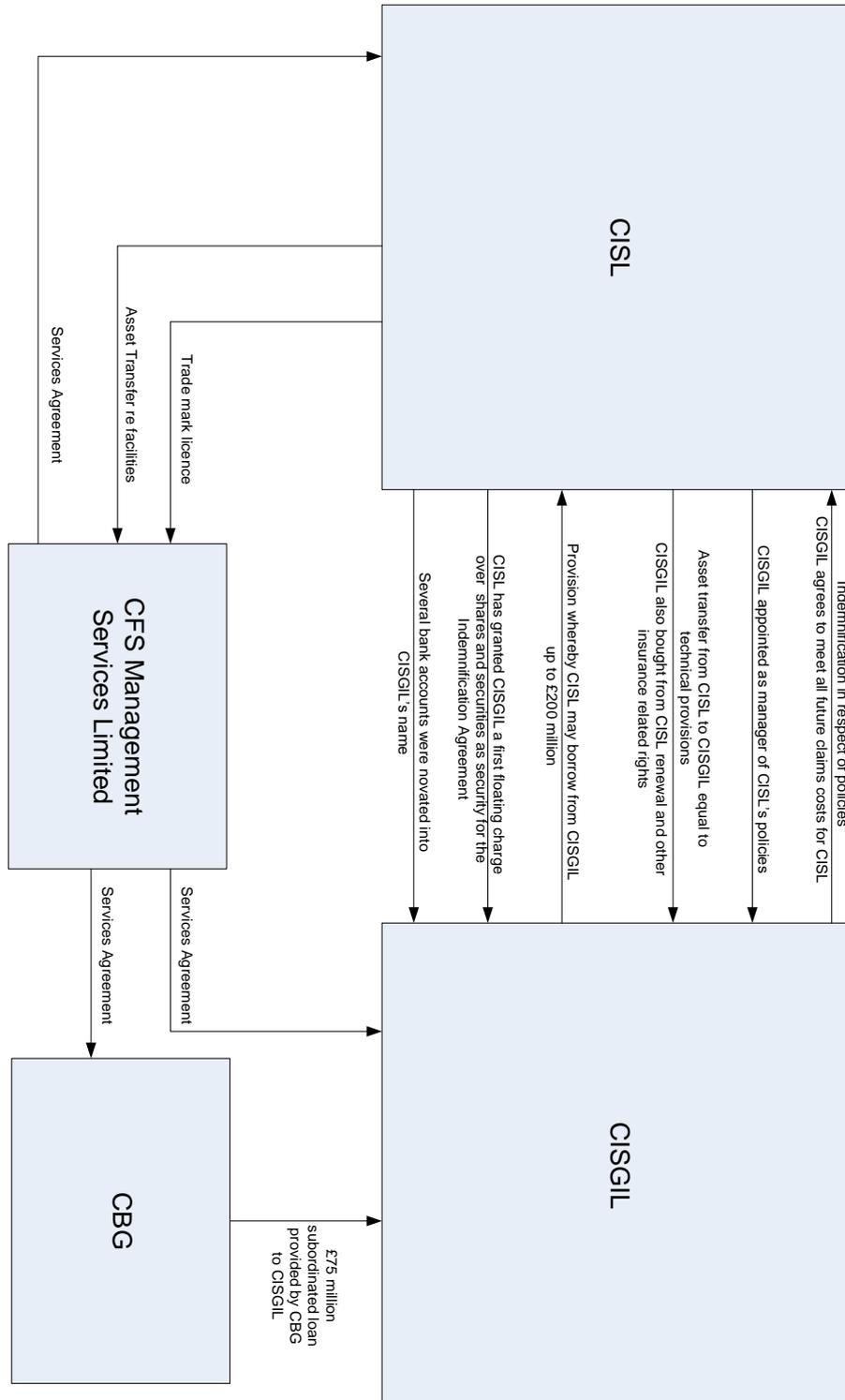
It should be noted that the above shows just one direct subsidiary of Royal London. In fact, there are roughly 60, but none of the others are involved in the Schemes. In the context of the above diagram, "R L (CIS) Limited" represents Royal London (CIS) Limited.

Schemes Structure



## APPENDIX F SUMMARY OF DOCUMENTATION EXECUTED IN JANUARY 2006

F.1. The following diagram sets out schematically the Indemnity Agreement and the other related agreements executed January 2006. It should be understood that this represents the situation as at January 2006, not the current position.



## APPENDIX G MINIMUM CAPITAL REQUIREMENT FOR GENERAL INSURANCE BUSINESS AS AT THE 2012 YEAR-END

- G.1. In the UK the process of setting minimum solvency margins changed with effect from 2005. However, UK general insurers remain subject to statutory requirements based on EU Directives and, for the time being, provide their risk-based enhanced capital requirement (“ECR”) calculation to the FSA in private. In addition, all UK general insurers are required to make individual capital assessments (“ICAs”) of their own capital needs which will be used by the FSA when giving individual capital guidance (“ICG”).
- G.2. The minimum capital requirement (“MCR”), based on EU Directives, is calculated as the greater of:
- a premium measure
  - a claims measure
  - a prior year MCR measure
  - a minimum amount, currently set at €3.7 million.
- G.3. The premium measure (A) is based on gross adjusted premiums (P) as follows:
- If  $P \leq \text{€}61.3$  million then  $A1 = P \times 18\%$ ,  $A2 = 0$
  - If  $P > \text{€}61.3$  million then  $A1 = \text{€}11.00$  million,  $A2 = (P - \text{€}57.5 \text{ million}) \times 16\%$
  - $A = A1 + A2$
- G.4. The claims measure (B) for other than health insurance is based on gross adjusted incurred claims (C) as follows:
- If  $C \leq \text{€}42.9$  million then  $B1 = C \times 26\%$ ,  $B2 = 0$
  - If  $C > \text{€}42.9$  million then  $B1 = \text{€}11.2$  million,  $B2 = (C - \text{€}42.9 \text{ million}) \times 23\%$
  - $B = B1 + B2$
- G.5. A credit for reinsurance factor (r) is then determined as the ratio of net incurred claims over the 3 year period (to the valuation date) to gross incurred claims ratio over the same 3 year period. If  $r < 0.5$  then r is set to 0.5.
- G.6. The prior year MCR measure (M) is based on the MCR as at the prior financial year-end and changes in outstanding claims:
- Where net outstanding claims are greater than zero as at the end of the current and previous financial years then  $M = \text{Prior year MCR} \times \min(1, \text{net outstanding claims as at the end of the current financial year divided by the net outstanding claims as at the end of the previous financial year})$ ;
  - Where net outstanding claims are zero as at the end of the current and previous financial years then  $M = \text{Prior year MCR} \times \min(1, \text{gross outstanding claims as at the end of the current financial year divided by the gross outstanding claims as at the end of the previous financial year})$ ;
  - Where gross outstanding claims are zero as at the end of the current and previous financial year then  $M = \text{MCR as at the end of the previous financial year}$ .
- G.7. Minimum solvency margin =  $\max \{ \max (A,B) \times r, M, \text{€}3.7\text{m} \}$
- G.8. For the purposes of this calculation, inwards reinsurance business is treated as insurance business.
- G.9. The currency amounts within this calculation are subject to periodic revision.

## APPENDIX H OUTWARDS REINSURANCE PROGRAMMES FOR RLCIS

- H.1. I have been informed by CBG that the following is a complete list of the outwards reinsurance contracts against which either there are known outstanding reinsurance claim recoveries in respect of RLCIS or it is considered possible that new reinsurance claim recoveries could arise in respect of RLCIS. Contracts that are definitely closed or where it is considered extremely unlikely that new reinsurance claim recoveries could arise are not listed (these include Catastrophe, Marine, PA and Medical Expenses, Brucellosis, Foot & Mouth, Contractors all risks and Engineering).
- H.2. RLCIS also purchased excess of loss protection to cover an accumulation of losses arising from its inward account exposure. According to the terms of the cover there remains some outstanding liability in respect of that protection, RLCIS has chosen not to pursue further recoveries and so again that cover is excluded from the following list.

Reinsurance Contract Year	Contract	Description
2006	Motor excess of loss programme	Cover for large motor third party liability claims. Losses occurring basis of cover. Covers losses on policies written by both CIS Limited and CISGIL. Open claims.
2006	EL/PL excess of loss programme	Cover for large employers' and public liability claims on commercial policies. Losses occurring basis of cover. Covers losses on policies written by both CIS Limited and CISGIL. No open claims, but possible that claims could arise.
2006	Fac Oblig One treaty	Cover for large commercial property risks. Risks attaching basis. Contract covers risks written by both CIS and CISGIL - however no open claims and unlikely that any will materialise
2006	Fac Oblig Two treaty	Cover for large commercial property risks. Risks attaching basis. Contract covers risks written by both CIS and CISGIL - however no open claims and unlikely that any will materialise
2006	Master Slip	Cover for large commercial property risks. Risks attaching basis. Contract covers risks written by both CIS and CISGIL - however no open claims and unlikely that any will materialise
2006	Facultative contract	A commercial property and loss of profits cover for the TUC policy (FT+PF 6666301). There are no open claims affecting this contract and unlikely that any will materialise.
2006	Subsidence reinsurance	Covers subsidence claims on household policies. Possibly some open claims - there were outstanding claims @ 31/12/09
2005 & Prior (from at least as far back as 1969)	Motor excess of loss programme	Cover as per 2006. 2005 contract was endorsed to cover policies issue by CISGIL, because covers losses occurring until 9th Feb 2006. All earlier years cover policies issued by CIS only. Open claims on several years' contracts and still potential for new claims to arise. Exact number of prior years that could be impacted needs further analysis.
2005 & Prior (from at least as far back as 1965)	EL/PL excess of loss programme	Cover as per 2006. 2005 contract was endorsed as a precaution to cover policies issued by CISGIL, although only covers losses occurring up to 14th Jan 2006, so endorsement was not necessary in hindsight. All earlier years cover policies issued by CIS only. No open claims, but possible that claims could arise. Exact number of prior years that could be impacted needs further analysis.
2005 & Prior	Surplus treaty	Cover for large commercial property risks. Underwriting year 2005 was closed @ 31/12/09, however subrogation recovery received during 2010 means that particular year will be re-opened for a one off refund to reinsurers expected to be completed by end Q1 2011. 2004 and prior closed. Unlikely that any further claims movements will materialise on any years.
2005 & Prior	Facultative contracts	Numerous contracts for each year covering individual commercial property (& associated loss of profits), EL/PL and fidelity guarantee risks. No open claims on any contracts, but the EL and PL contracts have the potential for claims to develop in the future. Exact number of prior years that could be impacted needs further analysis.
2005 & Prior	Subsidence reinsurance	Possibly some open claims - there were outstanding claims @ 31/12/09. Exact contract years impacted needs further analysis.
1995 and Prior (from 1966)	EL/PL excess of loss (Domestic)	Cover for large EL (domestic employees) or PL claims on household policies. Open claim affecting 1989 contract year. Potential for further claims to arise in future.

Contracts cover risks situated in the UK (including Northern Ireland, the Isle of Man and the Channel Islands), and contracts are governed according to English law.

## APPENDIX I OUTWARDS REINSURANCE PROGRAMMES FOR CISGIL

I.1. The following outwards reinsurance programme for the accident year 2012 was set out in CISGIL's Returns to the FSA as at 31 December 2012.

Accounting Class	Description of Reinsurance Cover	CISGIL's maximum retention	CISGIL's maximum net probable loss per contract	CISGIL's maximum net probable loss per class	Reinsurer's maximum capacity or indemnity	Period	Premium ceded Reinsurer's share of gross premium
<u>Accident &amp; Health</u> Outsourcing arrangement	i) Quota share	Nil	Nil	Nil	Unlimited	29/10/08 - 28/10/14	Facultative Nil Non-Facultative 0.90%
<u>Personal Lines</u> <u>Motor</u>	i) Excess of loss	£3,800,000 any one event (indexed)	£3,800,000 any one event (indexed)	£3,800,000 any one event (indexed)	Unlimited	25/02/12 – 31/12/12	Facultative Nil Non-Facultative 2.46%
<u>Personal Lines</u> <u>Property</u>	i) Excess of loss	£20,000,000 any one event	£20,000,000 any one event	£20,000,000	£175,000,000 any one event	01/01/12 - 31/12/12	Facultative Nil Non-Facultative 5.39%
ii) Subsidence	ii) Quota share	Nil	Nil		£1,550,000	01/01/09 - 31/12/13	
iii) Liability to domestic employees	iii) Excess of loss	£2,000,000 any one event (indexed)	£2,000,000 any one event (indexed)		£8,000,000 any one event (indexed)	25/02/12 – 31/12/12	
<u>Personal Lines</u> <u>Financial Loss</u>							
i) IPA Home Rescue Plus	i) Quota Share	Nil	Nil	Nil	Unlimited	01/01/11 - 31/12/13	Facultative Nil Non-Facultative 21.10%
ii) IPA Road Rescue Plus	ii) Quota Share	Nil	Nil	Nil	Unlimited	01/01/12 - 31/12/12	
iii) IPA Home Owners Travel Advice & Assistance	iii) Quota Share	Nil	Nil	Nil	Unlimited	01/01/12 - 31/12/12	
iv) IPA Foreign use	iv) Quota Share	Nil	Nil	Nil	Unlimited	01/01/12 - 31/12/12	
v) IPA Road Rescue	v) Quota Share	Nil	Nil	Nil	Unlimited	01/01/12 - 31/12/12	
vi) IPA Home Rescue	vi) Quota Share	Nil	Nil	Nil	Unlimited	01/01/12 - 31/12/12	
<u>Motor Commercial</u>	i) Excess of loss	£3,800,000 any one event (indexed)	£3,800,000 any one event (indexed)	£3,800,000 (indexed)	Unlimited	25/02/12 – 31/12/12	Facultative Nil Non-Facultative 6.20%
ii) Outsourcing arrangement	ii) Quota Share	nil	nil		Unlimited	29/10/08 - 28/10/14	

Accounting Class	Description of Reinsurance Cover	Society's maximum retention	Society's maximum net probable loss per contract	Society's maximum net probable loss per class	Reinsurer's maximum capacity or indemnity	Period	Premium ceded Reinsurer's share of gross premium
<u>Property Commercial</u>							
i) Terrorism	i) Risk excess	£100,000 per event; £200,000 in the aggregate	£100,000 per event; £200,000 in the aggregate	£200,000	Unlimited	01/01/12 - 31/12/12	Facultative Nil Non-Facultative 102.12%
ii) Outsourcing arrangement	ii) Quota Share	nil	nil		Unlimited	29/10/08 - 28/10/14	
<u>Commercial Lines Liability</u>							
Outsourcing arrangement	Quota Share	Nil	Nil	Nil	Unlimited	29/10/08 - 28/10/14	Facultative Nil Non-Facultative 91.74%
<u>Commercial Lines Financial Loss</u>							
i) Bonds	i) Quota Share	Nil	Nil	Nil	£10,500,000 aggregate in any one year	01/01/12- 31/12/12	Facultative Nil Non-Facultative 87.62%
ii) Outsourcing arrangement	ii) Quota Share	Nil	Nil	Nil	Unlimited	29/10/08 - 28/10/14	
<u>MAT Direct</u>							
Outsourcing arrangement	Quota share	Nil	Nil	Nil	Unlimited	29/10/08 - 28/10/14	Facultative Nil Non-Facultative 100.00%

1.2. CISGIL's major Treaty reinsurers during 2012 were as follows:

Reinsurer	Premiums payable to reinsurer by CISGIL during 2012 (£'000)	Anticipated recoveries from this reinsurer (£'000)
Underwriting members of Lloyd's	4,595.1	3,625.2
Faraday Re	1,077.2	5,976.9
Everest Re	nil	2,964.9
Swiss Re	2,135.5	1,514.5
Validus Re	399.6	nil
Hannover Ruck	993.6	2,186.2
Munich Re	nil	349.6
New Re	nil	293.3
R&V Re	1,744.9	4,072.3