Sun Life Assurance Company of Canada (U.K.) Limited

Report on the terms of the Proposed Scheme of Arrangement by the Independent Expert under Part 26 of the Companies Act 2006

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GLOSSARY

This is a glossary of the acronyms used throughout the Scheme Report.

B

BRV	Bonus Reserve Valuation

C

CA	Chief Actuary
Cannon Fund	Cannon Pension Fund Deposit Account
CIFRS	Canadian International Financial Reporting Standards
CL WPF	Confederation Life With-Profits Fund
COBS	Conduct of Business Sourcebook

F

FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act 2000

G

GFSC	Guernsey Financial Services Commission

I

ICA	Individual Capital Assessment

J

JFSC	Jersey Financial Services Commission

P

PPFM	Principles and Practices of Financial Management
PRA	Prudential Regulation Authority
PRE	Policyholders' Reasonable Expectations
PRIN	Principles of Business

S

SCR	Solvency Capital Requirement
SLFC	SLFC Assurance (UK) Limited (formerly Lincoln Assurance Limited)
SLFC WPF	SLFC Assurance UK With-Profits Fund
SLOC	Sun Life Assurance Company of Canada (U.K.) Limited
SLOC SSF	SLOC Segregated Sub Fund
SLOC WPF	SLOC With-Profits Fund

T

TAS	Technical Actuarial Standards
TCF	Treating Customers Fairly

W

WPA	With-Profits Actuary
WPC	With-Profits Committee
WPF	With-Profits Fund

1. INTRODUCTION

Instructions

1.1 I have been instructed by Sun Life Assurance Company of Canada (U.K.) Limited ("SLOC") to report in the capacity of an Independent Expert on the terms of a Scheme of Arrangement (the "Scheme") under Part 26 of the Companies Act 2006, the purpose of which is to seek the agreement of certain SLOC policyholders to a variation in the terms of their contracts.

1.2 The scope of the work undertaken was to consider the terms of the Scheme, having regard to:

- The current position of the SLFC Assurance UK With-Profits Fund (the "SLFC WPF"), the fund within SLOC to which the affected policyholders are allocated and which is to be restructured, its position within SLOC and its need for some form of restructuring;
- The terms of the Scheme;
- The proposed voting arrangements and their fairness to affected policyholders;
- The effects of the Scheme on the SLFC WPF policyholders; and,
- The effects of the Scheme on SLOC's other policyholders, both within its other with-profits fund and within the non-profit fund,

and provide a comprehensive report (the "Scheme Report") on these matters to enable the Court to consider the proposed Scheme.

1.3 The Scheme will be presented to the High Court of Justice in England and Wales ("the Court") for sanction. My report is to be made available to the Court to assist it in assessing the terms of the Scheme. A previous version of this report dated 18 October 2016 was submitted to the court and is replaced by this version, which addresses a clarification to the nature of the bonuses accruing to Trident policyholders.

Purpose of the Scheme Report

1.4 My appointment as an Independent Expert has been approved by the Prudential Regulation Authority ("PRA") in consultation with the Financial Conduct Authority ("FCA") which have responsibility for regulatory oversight of insurance companies in the UK. My terms of reference, which include rules on expert evidence, are set out in Appendix 1.

1.5 A company proposing a Scheme of Arrangement with its creditors must set out the financial arrangements which are to apply to the affected creditors' interest and to obtain consent on a class basis from those creditors. For the company to achieve consent, more than 50% by number of affected creditors who vote and at least 75% by value of their interest must vote in favour. In the case of the Scheme, the creditors are the affected policyholders in the SLFC WPF and they will be invited to vote on the Scheme. However, given the nature of life insurance contracts, policyholders may have difficulty in assessing the adequacy or fairness of the financial terms offered to them. Additionally, the Court may require assistance in assessing whether the values to be placed on insurance contracts results in an appropriate weighting of them for voting purposes. Finally, since the terms of the Scheme, if approved, will result in a change to the overall structure of SLOC's long term business fund, the PRA and FCA, in furthering their regulatory obligations, seek comfort that the Scheme will not have an unintended adverse effect on other policyholders of SLOC who will not be invited to vote on the Scheme.

1.6 My instructions as set out in 1.2 reflect these requirements and the scope of the Scheme Report is to address these issues and assist those parties in considering the Scheme.

1.7 In preparing the Scheme Report, I have had regard to the equity of the proposals amongst the various groups of policyholders (reflecting the varying nature of the contractual rights which policyholders have and the operation of their policies), the security of benefits in each fund both before and after the implementation of the Scheme, the policyholders' reasonable expectations created by the past practices employed or statements made by SLOC and, more generally, that the proposals treat policyholders fairly. In particular, although the Scheme will affect directly only with-profits policyholders of the SLFC WPF, I have also considered the likely effects of the Scheme, if any, on the operational and financial arrangements for the management of SLOC's business as a whole which may impact on the other policyholders of SLOC (who will not be invited to vote on the proposals).

1.8 In assessing the impact of the Scheme on policyholders' expectations and whether those policyholders are being treated fairly in the implementation of the Scheme, I have had regard to the reports of SLOC's With-Profits Actuary ("WPA") and SLOC's Chief Actuary ("CA") on the Scheme.

1.9 As far as I am aware, there are no matters which I have not taken into account in undertaking my assessment of the Scheme and in preparing this report but which nonetheless should be drawn to the attention of policyholders or the Court in their consideration of the terms of the Scheme.

1.10 I have also reviewed and considered the contents of the documents describing the proposals (the Explanatory Statement, the "Questions & Answers" Leaflet, and the policyholder letter) which will be sent to the policyholders of the SLFC WPF. Advanced drafts of these documents were available to me at the date of the Scheme Report.

Structure of the Scheme Report

1.11 The Scheme Report is structured as follows:

- Section 2 outlines the background of the structure and relevant operating practices of SLOC;
- Section 3 outlines the nature of the contractual rights of the policyholders of the SLFC WPF and the financial situation of the SLFC WPF;
- Section 4 outlines the terms of the Scheme;
- Section 5 considers the financial terms offered to policyholders of the SLFC WPF;
- Section 6 considers the security of benefits under SLOC policies on implementing the Scheme;
- Section 7 considers the weighting to apply to contracts for voting purposes;
- Section 8 addresses the impact of the Scheme on SLOC's other policyholders;
- Section 9 address the impact of the Scheme on SLOC's shareholders;
- Section 10 summarises my conclusions; and,
- Section 11 sets out my certificate of compliance with Court requirements as an Expert Witness.

Regulatory and Professional Guidance

1.12 The Scheme Report has been prepared in compliance with applicable rules on expert evidence.

1.13 There is no directly relevant regulatory guidance relating to reports of this nature but the Scheme Report has general regard to the requirements of the PRA Rulebook (and relevant Supervisory Statements) and the FCA Handbook. In considering the terms of the Scheme, I have had particular regard to the Conduct of Business Sourcebook rules ("COBS") and to FCA's Principles for Business ("PRIN").

1.14 A Technical Actuarial Standard: Transformations ("Transformations TAS") has been issued by the Financial Reporting Council to apply to reports or work produced in support of the reorganisation of financial organisations. In my opinion, the Scheme Report complies with the Transformations TAS and is compliant with those elements of the Technical Actuarial Standards on Data, Modelling and Reporting (TAS-D, TAS-M and TAS-R, respectively) and the Insurance TAS which are applicable to transformations.

1.15 The Scheme Report has been subject to peer review by one of my colleagues at Milliman (who has not otherwise been involved in the preparation of the Scheme Report) in accordance with both Milliman's risk and quality procedures and the requirements of the APS-X2 standard issued by the Institute and Faculty of Actuaries. However, the opinions and conclusions set out in the Scheme Report remain my own.

1.16 I have also had regard to guidance issued by the Institute and Faculty of Actuaries for actuaries acting as an expert witness.

Qualifications and Disclosures

1.17 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 Faculty of Actuaries in 1980. I am the holder of a Chief Actuary (Life) practising certificate, an Actuarial Function Holder/ Reviewing Actuary practising certificate, and a With-Profits Actuary practising certificate issued by the Institute and Faculty of Actuaries, which permits me to practise in certain reserved actuarial functions relating to life insurance business in the UK.

1.18 I have prepared this report as a Consulting Actuary for Milliman LLP ("Milliman"), based in London. I have more than 40 years' experience in the UK life insurance industry, including experience as an appointed actuary or actuarial function holder and with-profits actuary, and have acted previously in the capacity of an Independent Expert under the terms of the Financial Services and Markets Act 2000 ("FSMA") or for the purposes of Part 26 of the Companies Act 2006, and as an independent actuary under the Insurance Companies Act 1982.

1.19 I acted as independent Expert for SLOC in 2014 regarding a Scheme of Arrangement affecting policyholders in the Cannon Pension Fund Deposit Account ("Cannon Fund"). I also assisted one of my colleagues who acted as the Independent Expert in the preparation of his report on the terms of the Insurance Business Scheme by which the SLFC WPF was transferred to SLOC in 2011. I am not a policyholder of SLOC. I have no financial interests in, nor am I a customer of, Sun Life Financial Inc., the ultimate parent company of SLOC, or any of its subsidiaries.

Reliances and Limitations

1.20 In preparing this report, the principal documents which I have reviewed are listed in Appendix 3.

1.21 I have been given free access to any additional documentary evidence held by SLOC which I have requested to allow me to investigate all aspects of the Scheme. In addition, I have had access to and discussions with the management and their professional advisers to assist in the completion of the Scheme Report. I have relied on the accuracy of the information which has been provided to me, and have not verified it independently. I have considered, and am satisfied with, the reasonableness of this information from my own experience in the insurance industry.

1.22 This report, and any extract or summary thereof, has been prepared particularly for the use of the bodies or persons listed below:

- The Court;
- SLOC's directors;
- The PRA and FCA, or any other governmental department or agency having responsibility for the regulation of insurance companies in satisfaction of a legal requirement to provide a copy; and,
- The professional advisers of any of the above, including, for the avoidance of doubt, the CA and WPA of SLOC.

1.23 The Scheme Report considers matters as at the date of its completion and, where appropriate, considers both short and long term issues which will affect SLOC and its policyholders. However, in the event that any material changes to the management or solvency position of SLOC may occur between the completion of the Scheme Report and the final Court Hearing and which may influence my assessment of the Scheme, I will prepare a supplementary report.

1.24 Copies of the Scheme Report may be made available for inspection by policyholders, either in physical form or on the SLOC website and may be provided to any person requesting the same in accordance with legal requirements. I will provide a summary of the Scheme Report which will be sent to policyholders along with the other documents describing the Scheme.

1.25 Neither the Scheme Report nor any extract from it may be published without my specific written consent having been given, save as set out in section 1.24. In addition, no summary of this report may be made without my express consent.

1.26 The Scheme Report has been prepared within the context of the assessment of the terms of the Scheme. No liability will be taken for application of this 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 Scheme Report. In particular, no liability will be accepted under the terms of the Contracts (Rights of Third Parties) Act 1999.

1.27 Nothing contained in the Scheme Report should be taken as investment advice, either regarding SLOC's products, the products of its subsidiaries or associates, or any financial instruments issued by Sun Life Financial Inc. or its subsidiary companies.

1.28 I am available to assist any of the parties listed in 1.22 above in interpreting this report.

2. BACKGROUND TO SLOC

Background

2.1 SLOC is an indirect subsidiary of Sun Life Financial Inc., a Canadian corporation. SLOC is a shareholder owned insurance company authorised and regulated by the PRA and regulated by FCA under the terms of FSMA. It is authorised to undertake long term insurance business in Classes I, II, III, IV, VI and VII[1]. The company also holds outward "passports" under the Freedom of Services Directive, which allow it to undertake insurance business in all EEA countries and in Gibraltar.

2.2 SLOC is also authorised to undertake insurance business in or from within Jersey by the Jersey Financial Services Commission ("JFSC"). SLOC holds a category A permit and is authorised to carry on long term insurance business in Classes I, II, III, IV, VI and VII[2]. SLOC does not have specific permissions or approvals in Guernsey but is treated as a recognised insurer by the Guernsey Financial Services Commission ("GFSC") since (as described in 2.1) it is authorised by the PRA in the UK.

Structure and Operation

2.3 SLOC maintains a number of sub-funds:

- SLOC With-Profits Fund ('SLOC WPF');
- SLFC WPF; and,
- the SLOC Non-Profit Fund ("Non-Profit Fund").

2.4 SLOC also maintained a further two funds during 2015:

- the Confederation Life With-Profits Fund which was discontinued on 31 March 2015 under the terms of an earlier Court-approved Scheme of Arrangement; and,
- the Shareholder Fund which was not required to be maintained as a distinct and identifiable fund after 1 January 2016 following the introduction of the new solvency regime known as Solvency II. Although SLOC currently continues to maintain its Shareholder Fund, for the purpose of the Scheme Report, the assets and liabilities of this fund have been amalgamated with those of the Non-Profit Fund.

The Confederation Life With-Profits Fund and the Shareholder Fund are not considered further in the Scheme Report.

2.5 Each of the sub-funds is closed to new business, apart from increments on existing plans, policyholders exercising options contained in their contracts, new members of existing group schemes and a small proportion of annuity contracts on vesting pensions business. New contracts are allocated to the same fund as the original contract with the exception of new non-profit contracts arising from options on with-profits contracts which are allocated to the Non-Profit Fund.

The SLOC WPF

2.6 The SLOC WPF consists of the with-profits business written by SLOC since 2000 or transferred to it and allocated to the SLOC WPF under the terms of a Court approved Scheme ("SLOC 1999 UK Scheme") which was part of the demutualisation process of Sun Life Assurance Company of Canada. As a result of the SLOC 1999 UK Scheme, SLOC's shareholders are not entitled to receive any share of the profits of the SLOC WPF, and all profits distributed in the SLOC WPF are only attributed to the with-profits policies allocated to it. The terms of the SLOC 1999 UK Scheme which may influence the operation of the SLOC WPF are described further below.

[1] Classification of long term insurance business: I - life and annuity, II - marriage and birth, III - linked long term, IV - permanent health, VI - capital redemption contracts and VII - pension fund management.

[2] The JFSC uses the same classification of long term business as the PRA as set out in footnote 1.

2.7 Under the terms of the SLOC 1999 UK Scheme, SLOC was required to maintain a ring fenced fund of assets, known as the SLOC Segregated Sub Fund ("SLOC SSF"), in the Non-Profit Fund to provide capital support for the SLOC WPF. The SLOC SSF can be used to support the SLOC WPF in extreme adverse economic circumstances if guarantees in policies in the SLOC WPF become exposed to the extent that the assets in the SLOC WPF do not cover its liabilities, and shortfalls are not reasonably recoverable by the application of the smoothing[3] process.

2.8 The SLOC SSF need not be maintained after 22 March 2010 if in the opinion of the SLOC WPA, and subject to regulatory approval, it is not required to support the SLOC WPF. The SLOC SSF is maintained currently.

The SLFC WPF

2.9 The insurance business of SLFC Assurance (UK) Ltd, an associate company of SLOC, was transferred to SLOC in 2011 under the terms of an Insurance Business Scheme under FSMA (the "2011 Scheme"). The SLFC WPF was transferred to SLOC as part of this transfer.

2.10 The SLFC WPF consists of the with-profits business written by or transferred to SLFC prior to June 1990 when the fund was closed to new business. The treatment of items such as charges, expenses and tax within the fund are defined by the terms of previous schemes of transfer. This fund and its business are discussed more fully in Section 3.

2.11 SLOC's shareholders are entitled to participate in any surplus distributions made to with-profits policies written in the SLFC WPF. This is described further in section 3.3.

The Non-Profit Fund

2.12 All other business transacted by SLOC is allocated to the Non-Profit Fund, which, as noted in 2.4, now includes the assets and liabilities formerly allocated to the Shareholder Fund. Profits arising in the Non-Profit Fund accrue to the shareholder. These profits may be retained in the Non-Profit Fund or they may be made available for payment as dividends to SLOC's shareholders, subject to any legal or regulatory constraint which may apply. As noted in 2.7 above, the SLOC SSF is a component of the Non-Profit Fund.

Approach to Financial Management and Policyholders' Reasonable Expectations

Overview

2.13 For the purpose of the Scheme Report, it will not be necessary to consider in detail the approach to financial management for each fund maintained by SLOC. As will be discussed later in this report, other than the changes to SLFC WPF (and the consequent allocation of the impacted policies to the Non-Profit Fund), no changes are proposed to the financial management of any sub-funds of SLOC. However, to the extent that all of the funds are part of SLOC, changes in the dynamics of one part of SLOC could affect another. The following paragraphs provide an overview of relevant aspects of financial management. A fuller description of SLOC's financial management and financial position is set out in Appendix 2.

Administration

2.14 Policy administration is outsourced and is largely undertaken by the third party administrators under commercial arrangements which provide for fixed expense tariffs (subject to inflation).

2.15 Investment management and administration are provided through agreements with a number of related and third party providers. These arrangements are subject to commercial contractual terms and protections.

2.16 The costs allocated to the SLOC WPF and the SLFC WPF are subject to terms arising from the previous transfers.

[3] "Smoothing" refers to the process used to manage the year-on-year change in with-profits payouts to ensure equity between different generations of with-profits policyholders and maintain the solvency position of the remaining with-profits business. It is primarily used to limit the impact of short term investment volatility on with-profits payouts and is typically intended to be cost neutral in the medium to long term.

Regulatory constraints

2.17 Under the current regulatory regime, the principle of treating customers fairly ("TCF") should be applied. This requires actions to be considered by reference not only to the way such actions may have applied in the past but also to whether they are fair in an absolute sense. The principle of TCF goes much further than simply recognising policyholders' reasonable expectations ("PRE"). The key features which I believe should be considered in addressing TCF and PRE are:

i. Security of benefits: this is the expectation that benefits will be paid as they fall due; and,

ii. Fair treatment: this must be assessed in the context of the effects which actions may have on different classes or generations of policyholders or on shareholders and should have regard to contractual terms and the way in which the contracts have been promoted and managed in the past.

With-profits business

2.18 A detailed description of the financial management of with-profits business is now set out in the statement of "Principles and Practices of Financial Management" ("PPFM") which with-profits companies must maintain and make available to policyholders. I have taken the full PPFM as the starting point in my assessment of the management of with-profits business. SLOC publishes PPFM for the SLOC WPF and separately for the SLFC WPF. The PPFM for the SLOC WPF is outlined at 2.21, and the PPFM for the SLFC WPF is considered in Section 3. These PPFM reflect the terms of the prior schemes noted above and I have relied upon these documents providing an accurate description of the practical application of the terms to the management of each of the funds. In the SLFC WPF, with-profits benefits are determined by the Fund's Prospective Value. The Prospective Value equals the present value of the expected future benefits, expenses and shareholder interest in future profits less expected future premiums. The present value reflects the time value of money, and requires an assumption on the future investment return on the Fund's assets. A policy's Prospective Value is also known as a Bonus Reserve Valuation ("BRV"). Management of the SLFC WPF is discussed in more detail in Section 3 of the Scheme Report.

2.19 In the SLOC WPF, with-profits benefits are determined by reference to the asset share (effectively an accumulation of premiums paid less charges, see Appendix 2) for all policy types other than whole of life policies which use the BRV method described in 2.18. In practice, subject to smoothing, the asset share serves as a reference point from which fair payouts could be measured for with-profits policyholders.

2.20 In both cases, the calculations are influenced by past or expected investment performance, expenses and risk charges.

SLOC WPF PPFM

2.21 SLOC publishes PPFM for the SLOC WPF. The full PPFM describes in more detail the approach adopted in managing the SLOC WPF. The PPFM also reflects the terms of the SLOC 1999 UK Scheme.

2.22 The SLOC WPF has a set of overarching Principles which have the aim of:

- meeting all legal and regulatory requirements (including ensuring the fund remains solvent on a stand-alone basis), meeting the SLOC 1999 UK Scheme requirements and observing all policy contract terms;
- distributing the entire fund at a pace that ensures each policyholder receives a fair share of the whole fund;
- meeting all policyholders' reasonable expectations regarding payouts, including paying all guaranteed benefits as they fall due; and,
- managing the fund in a sound and prudent manner and treating all policyholders fairly having regard to their contribution.

2.23 Although all of these principles are important in terms of the management of the SLOC WPF, in the context of the Scheme Report and consideration of the Scheme, the key element to be noted is that investment strategy is set to achieve satisfactory benefits to with-profits policyholders, having regard for the financial strength of the SLOC WPF on a stand-alone basis without recourse to any other assets of SLOC. However, the SLOC WPF may rely on the SLOC SSF to support guaranteed benefit payments in extreme adverse economic circumstances in line with the requirements of the SLOC 1999 UK Scheme. Additionally, the benefits accruing may be affected by changes to the level of expenses allocated to the SLOC WPF.

Excess Surplus and Run-off Plans

2.24 A company transacting with-profits business is required to consider whether the capital available in each with-profits fund is in excess of the capital required to support the business plans and risk appetite of that fund. Where more than one with-profits fund is maintained, the test should be applied separately to each fund. If excess capital is identified, then a plan must be formulated to remove the excess through either distribution or reattribution of the capital.

2.25 Each of the with-profits funds maintained by SLOC has been effectively closed to new business for some years and therefore the distribution of assets in excess of the asset shares is already a feature of the management of these funds in their run off plans (and explicitly referred to in the Principles in the PPFM). The approach adopted demonstrates that, in each fund, a balance has to be struck between distributing the excess assets equitably and maintaining a satisfactory long term solvency position for each fund.

Capital

2.26 In practice, each of the with-profits funds should be managed to rely on its own capital. In very extreme circumstances all of the funds may have to rely on capital outside the with-profits funds if the funds became insufficient but they should not be managed with this expectation.

2.27 The SLOC WPF may rely additionally on the SLOC SSF in appropriate circumstances. The SLOC SSF is separately identified in the Non-Profit Fund but may be discontinued if it is determined by the Board and the WPA that it is not required to be maintained. However, until that step is taken, the effect of any structural changes in SLOC need to consider the continuing availability of the SLOC SSF to the SLOC WPF after the reorganisation.

Expense Allocation

2.28 The majority of costs incurred by SLOC are allocated by line of business:

- Investment expenses: this allocation is based on the assets attributable to each line of business.
- Policy administration that has been outsourced: the line of business attribution is based on the policy counts and contracted rates.
- Central overhead costs of managing SLOC and providing oversight to the outsourced arrangements: these are allocated to line of business using a weighted proportion of in-force policies for each line of business. The latter approach is also used to allocate the contributions to SLOC's staff pension scheme between the different lines of business.

2.29 The SLOC 1999 UK Scheme requires that the costs charged to the SLOC WPF in respect of policy administration should be based, in the view of the WPA, on a fair apportionment of the renewal expenses incurred. Any excess of the expenses incurred over those charged to the SLOC WPF is charged to the surplus in the Non-Profit Fund (i.e., effectively, the shareholder).

Unit-linked business and reviewable charges business

2.30 Discretionary powers are more limited in respect of unit-linked business. There are industry codes of practice and regulatory requirements which limit the scope of these powers and it is common for companies to maintain documents similar to (but much more limited in scope than) the PPFM describing how unit-linked business is managed. The scope is much narrower since financial management of unit-linked business does not rely materially on the amount of available capital. However, a change to the expense base of a company or a change to the balance of expenses allocated to business lines would affect benefits for unit-linked business if the change can be passed on to policyholders by way of increased charges.

2.31 SLOC documents its procedures for the financial management of its unit-linked business and its reviewable charges business.

Financial Position

2.32 On 1 January 2016, a new European-wide insurance regime ("Solvency II") came into force. Solvency II is not simply about solvency measurement and has far reaching implications across many areas of the management of insurance business, such as governance, risk management and reporting processes.

2.33 Solvency II differs fundamentally from the previous regime ("Solvency I") since it uses market consistent measures along with best estimates of liabilities ("BEL") and capital requirements which are determined having regard to the financial impact of 1-in-200 stresses occurring in respect of the risks borne by the firm. Solvency II also requires a margin (representing the assumed cost of holding capital in respect of certain risks) to be held (the "risk margin"). This contrasts with the Solvency I approach which required the value of liabilities to be determined on a prudent basis and the capital requirements to be determined on a formulaic basis with little regard to the underlying risk profile of the firm. In the UK, the Solvency I regime was underpinned by a risk-based approach, the Individual Capital Assessment regime ("ICA" or "Pillar 2") which reflected the firm's own assessment of the risks borne by it and the capital required to meet those risks. The ICA approach was similar to the Solvency II approach (although material differences also exist) but was reported privately to the PRA. SLOC has adopted the Standard Formula approach which requires a number of specified stresses to be applied to the balance sheet to determine the capital which it is required to hold. SLOC has not made use of any of the transitional measures available to firms (on application) which are designed to ease to the financial effects of implementing Solvency II.

2.34 At the date of the Scheme Report, SLOC has not been required to publish a statement of its initial Solvency II financial position, although it has submitted it to the PRA. The latest published financial returns of SLOC as at 31 December 2015 were based on Solvency I. I have considered the published returns (combined with unpublished information contained in the ICA) as a basis for assessing the way in which SLOC has managed its business historically and to determine the extent to which this may influence policyholder expectations. A brief discussion of the financial management of SLOC under Solvency I is set out in Appendix 2.

2.35 I have been provided with a statement (prepared by SLOC) of the Solvency II financial position showing the available assets ("Eligible Own Funds" in Solvency II terms) of SLOC and its Solvency Capital Requirement ("SCR"). The assumptions and methods used in the Solvency II calculations are similar to those employed in the Solvency I Pillar 2 calculations which SLOC has undertaken for a number of years and I consider the results to the Solvency II calculations to be consistent with those prior results. The Solvency II figures (including the basis and methodology used to derive them) have been subject to review by SLOC's external auditors who have indicated that they have been prepared in line with the requirements of Solvency II.

Figure 1: SLOC's Solvency II position

£million	31 December 2015	31 March 2016
NPF Assets (less current liabilities)	**7,232.0**	**7,186.2**
NPF BEL	(6,530.8)	(6,488.9)
NPF Risk Margin	(108.2)	(116.4)
NPF Technical Provisions	**(6,639.1)**	**(6,605.3)**
Eligible Own Funds ("EOF")		
- NPF	593.0	580.8
- SLOC WPF	3.0	3.0
- SLFC WPF	0.5	0.5
Total EOF	**596.4**	**584.3**
SCR		
- NPF	(284.5)	(285.9)
- SLOC WPF	(3.0)	(3.0)
- SLFC WPF	(0.5)	(0.5)
Total SCR	**(288.0)**	**(289.4)**
Excess Own Funds = Total EOF – Total SCR	**308.4**	**294.9**
Solvency Ratio = Total EOF / Total SCR * 100%	**207%**	**202%**
Proposed Dividends	(110.0)	(110.0)
Solvency Ratio after dividend = EOF (after dividend) / SCR * 100%	169%	164%

Source: CA Report on the Scheme

2.36 Figure 1 demonstrates that SLOC is well capitalised under the new regime, with available capital (Total EOF) covering the SCR by 207% as at 31 December 2015. Since SLOC has resolved to pay a dividend to its shareholder, but this had not been paid by 31 March 2016, it is appropriate to allow for the payment in assessing the solvency position. This reduces the cover for the SCR to 169% as at 31 December 2015.

2.37 Since the end of 2015, financial markets have been under some stress and have been volatile, reflecting concerns over Brexit, a global slowdown driven by a perceived slowdown in the Chinese economy, and ongoing challenges in the Eurozone. During the first quarter, UK equity markets fell by 10-15% but subsequently recovered to more or less the year end position. A more material financial stress was experienced from a fall in the risk-free swaps curve which underpins the calculation of liabilities in Solvency II. The fall registered was extreme relative to the stress calibrated in the Standard Formula test for determining the SCR, and as at the date of the Scheme Report has shown no sign of recovery (although the rates have been stable for some time). Despite this market stress, the Solvency II position as at 31 March 2016 was not much different from the year-end, with Total EOF still providing cover of 164% cover for the SCR. The light impact reflects the nature of SLOC's business, particularly in its Non-Profit Fund which is principally linked business.

2.38 SLOC has adopted a minimum capital standard of seeking to maintain the cover for the SCR at 150%. Given the nature of SLOC's business and that it is not transacting new business, I consider that this standard provides reasonable level of cover to ensure that SLOC can still meet its SCR in the face of moderately severe experienced stresses.

2.39 It can be seen that the bulk of the EOF is located in the Non-Profit Fund, and that the bulk of the SCR also relates to the business of that fund. However, the EOF are generally available to cover SLOC's total SCR, including the SCR for each of the with-profits funds which are clearly trivial by comparison with that of the Non-Profit Fund.

2.40 Figure 1 also demonstrates that each of the with-profits funds just met its own SCR but this is a consequence of the way in which with-profits funds in run-off are treated in Solvency II (as ring fenced funds distributing capital to relevant eligible participants). The position for the SLFC WPF is expanded upon in 3.31.

3. BACKGROUND TO THE SLFC WPF

Background

3.1 The SLFC WPF was created by the transfer to SLOC in 2011, but is an amalgamation of the businesses of a number of other funds under earlier Court approved schemes of transfer:

- Laurentian Life With-Profits Fund in 1996;
- Imperial Life With-Profits Fund in 1987; and,
- Trident Life With-Profits Fund in 1987.

3.2 The Court Schemes governing these transfers set out how tax, expenses and charges should be treated and these requirements are reflected in the PPFM for the SLFC WPF.

3.3 The Laurentian Life with-Profits Fund had two sections, which are still maintained within the SLFC WPF:

- The larger section is Imperial Life business issued before 1 July 1987. Shareholders are entitled to at most 2.5% of the surplus on these policies, and policyholders are entitled to at least 97.5%.
- The smaller section is Imperial plans issued on or after 1 July 1987 and plans issued by Trident Life. Shareholders are entitled to at most 10% of the surplus arising on these policies, with policyholders being allocated the remaining surplus.

3.4 As a result of the entitlements set out in 3.3, SLOC's shareholders received 2.5% of surplus distributed in respect of Imperial with-profits policies in the fund in 2015, and 9.56% in respect of Trident with-profits policies.

Products

3.5 The with-profits contracts in the SLFC WPF mainly consist of whole of life and endowment policies. There is a minimal amount of reinsurance in place in the SLFC WPF.

3.6 The non-profit business in the SLFC WPF (principally unit linked business, which does not participate in profits) was transferred to the Non-Profit Fund during 2015 under the terms of an internal arrangement. This transfer was scrutinised by the WPA and the WPC as being a reasonable and appropriate transaction which would reduce the capital requirements of the SLFC WPF and increase the liquid capital available in the SLFC WPF.

3.7 In the rest of this Scheme Report, when I refer to the SLFC WPF policyholders, it should be taken as referring to the with-profits policyholders in the SLFC WPF only.

3.8 Most of the policies issued before 1983 contain options that give policyholders the right on death, maturity or surrender to leave benefits in an interest bearing current account; or to take benefits as an annuity on guaranteed rates ("settlement options"). The possible options are as follows:

- Option A: A policyholder can deposit the policy proceeds for a fixed period and receive a guaranteed return of 3% pa.
- Option B: A policyholder's plan proceeds can be spread into fixed instalments payable over a period of up to 30 years and giving a return equivalent to 3% pa.
- Option C: A policyholder can deposit the policy proceeds for a fixed period and receive a guaranteed return of 3% pa, and also take a fixed income of at least 5% pa of the original deposit until the proceeds are exhausted.
- Option D: A policyholder takes the proceeds in fixed instalments payable over a lifetime of a specified person, subject to a minimum period if the person dies early. The guaranteed period is 5, 10 or 15 years.
- Option E: As for Option D, but the proceeds are payable whilst either of two named people are alive.

3.9 The definition of "policyholder" for this purpose is quite wide since beneficiaries under these policies would also have the right to exercise the option. These options are currently in the money (i.e., valuable to policyholders), and could represent a significant liability to the SLFC WPF. Policyholders have been reminded of these options since August 2006, and although take-up rates have been low they have increased significantly since 2013 and have become much more costly in the very low yield environment. These options have only been exercised to date under endowment policies and recent experience would indicate an increasing take-up rate amongst these policies. The following table shows the take-up rate of each option and the estimated average cost since 2006.

Option	2006 – 2009	2010	2011	2012	2013	2014	2015 (up to November)	Average Cost of Option*, £
Number of exits (Endowment)	2000	390	322	458	360	322	270	
A	0.50%	0.77%	3.11%	1.97%	9.72%	11.49%	12.96%	844
B	0.10%	0.26%	-	0.44%	1.11%	0.93%	1.11%	609
C	0.00%	-	0.31%	-	-	0.31%	0.37%	2,435
D	0.10%	-	-	0.22%	0.83%	0.31%	-	11,829
E	-	-	-	-	-	-	-	-
Total	0.70%	1.02%	3.42%	2.62%	11.67%	13.04%	14.44%	1,320

*per policy exercising one of the options

Source: CA report on the Scheme

Current in-force and recent experience

3.10 Figure 2 gives the number of policyholders and the Solvency II best estimate liabilities for the in-force SLFC WPF policies.

Figure 2: SLFC WPF in-force statistics (Solvency II basis)

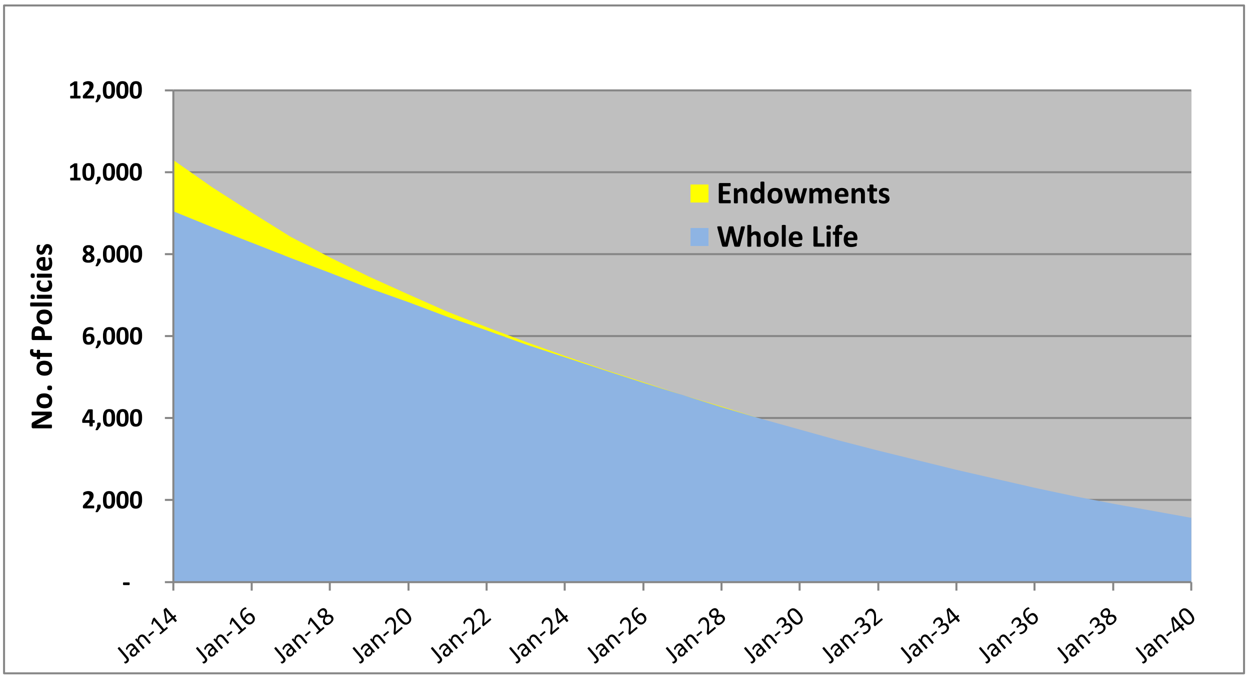
	31 December 2015		31 March 2016	
	No. of policies	Best Estimate Liabilities £000s	No. of policies	Best Estimate Liabilities £000s
With-profits policies:				
Endowment (Imperial)	984	9,143	913	8,524
Whole Life (Imperial)	8,640	95,451	8,558	99,539
Whole Life (Trident)	31	214	29	207
Endowment (Trident)	1	5	0	0
Pension (Imperial)	4	14	3	11
Settlement options & other reserves on with-profits policies	-	432	-	409
Total with-profits policies	**9,660**	**105,258**	**9,503**	**108,690**

Source: CA report on the Scheme

3.11 Figure 2 shows how the SLFC WPF is reducing over time. The rate of decline in the number of with-profits policies in force shown is in line with that seen in recent quarters, at approximately 1.7% per quarter, but also shows the rather faster decline in the number of endowment policies. Figure 3 shows the expected run-off by number of policies of the SLFC WPF over the long term.

3.12 The best estimate liabilities have increased over the first quarter (rather than decreasing in line with policy numbers) since the risk free rate used to calculate them has fallen quite significantly. The best estimate reserve shown for the liability under the settlement options has been calculated on the Canadian International Financial Reporting Standards ("CIFRS") basis for several years and has been relatively stable using this basis. The take-up rates assumed were 1% until 2018; 2% for the following five years and gradual increases of 1% for each 5 year period thereafter, all of which are substantially lower than the experienced rates over the last three years but this is offset by basing the reserve on the higher cost options. I note that the reserve for the settlement options has reduced from £0.56 million as at 31 December 2014, and that this is due to a re-assessment of the underlying mortality basis and a refinement in the calculation of the contingencies upon which the option may be exercised. The reserve for the settlement options seen in Figure 2 has declined in line with the reduction in the number of policies but, since it has been calculated by reference to a market interest rate and not by reference to the lower risk free rate, it has not shown the change seen in other reserves over the first quarter of 2016.

Figure 3: Expected run-off of SLFC WPF



Source: Sun Life of Canada

Approach to Financial Management and Policyholders' Reasonable Expectations

SLFC WPF's PPFM

3.13 SLOC publishes PPFM for the SLFC WPF, the latest version being dated July 2015.

3.14 A set of overarching Principles applies to the SLFC WPF (which are materially the same as those that apply to the SLOC WPF):

- meeting all legal and regulatory requirements (including ensuring the fund remains solvent on a stand-alone basis), meeting requirements imposed by previous transfer schemes, and observing all policy contract terms;
- distributing the entire fund at a pace that ensures each policyholder receives a fair share of the whole fund;
- meeting all policyholders' reasonable expectations regarding payouts, including paying all guaranteed benefits as they fall due; and,
- managing the fund in a sound and prudent manner and treating all policyholders fairly having regard to their contribution.

3.15 The key elements of the Principles are:

- Benefit payments to policyholders are determined by equating the Prospective Value of in-force plans to the value of the Fund's net assets;

- Reversionary bonuses are set so as to ensure that a balance is maintained between regular and terminal bonus payouts and that the build-up of guarantees is restricted so as to protect the fund's solvency. Terminal bonuses are set so the Prospective Value equals the Fund's net assets;
- Smoothing is included in the calculation of the Prospective Value; it is intended that the process will be cost neutral over the long term;
- The investment strategy adopted for the Fund aims to meet the cash inflows and outflows of the Fund. The investment strategy aims to take into account the constraints placed by the rapid run-down in the Fund and the guarantees and options that the Fund will need to meet;
- There is currently no differentiation by generation or class of with-profits policyholders for the apportionment of expenses; and,
- The Inherited Estate is managed so as to maintain the statutory solvency of the Fund, meet the cost of guarantees, ensure pay outs correspond to a fair share of the Fund and enable investment freedom.

3.16 The SLFC WPF is no longer open to new business, except for any existing contractual obligations, and is already managed as a closed fund.

3.17 When SLOC considers that the SLFC WPF is no longer viable to continue as a separate entity due to its small size, the PPFM allows SLOC to seek an agreement to convert the with-profits plans to non-profit and merge with another fund; or to take other alternative action.

Financial Management of the SLFC WPF in practice

3.18 The investment strategy utilised by the SLFC WPF is principally based on fixed interest investments, which reflects the nature of the underlying liabilities and the overall approach to managing bonuses. The SLFC WPF has typically been invested in gilts and corporate bonds (with a small cash balance for liquidity). At 31 December 2014, the SLFC WPF was invested 47% in corporate bonds, 51% in government bonds, and 2% in cash, and this was little changed at 30 September 2015 at 44%, 52% and 4%, respectively. However, in recent months, the investment strategy has been re-appraised and the proportion allocated to corporate bonds has reduced. As at 31 March 2016, corporate bonds comprised 37% of the assets, while 61% was invested in gilts and 2% in cash. The allocations remain within the investment guidelines set out in the PPFM.

3.19 The previous Schemes establishing the SLFC WPF have set the rules for determining expenses. The SLFC WPF meets all the expenses directly attributable to it. Indirect costs are attributed to it through an appropriate proportion of SLOC's overall costs. Development costs are only attributed to the extent that the changes would benefit the SLFC WPF. Management costs paid to related companies will not be more than the costs the related company incurred.

3.20 The main expenses of the SLFC WPF are allocated as follows:

- Investment management expenses incurred in respect of linked business are charged directly to the linked funds. Other charges made to the SLFC WPF for investment expenses are based on a proxy rather than the actual level of expenses incurred.
- Where policy administration services have been outsourced, expenses are allocated by line of business using policy counts and the contracted rates. Internal administration costs are allocated by pre-defined splits.
- Overhead costs allocated have been derived since 2011 on a basis which used the mathematical reserves and the costs paid to the outsourcers as weights. The method was modified in respect of 2013 and 2014 by taking the previous year's overhead charge, inflated at RPI +1% p.a., but reduced by reference to the number of policies in force. However, since this formula has resulted in a growing subsidy to the SLFC WPF from the shareholder assets as the SLFC WPF has declined in size, the formula was amended during 2015 so that, effectively, the cost allocated in the future will be derived as the implied unit overhead cost in 2014 increased by RPI +3.5% p.a. multiplied by the number of SLFC WPF policies in force.
- Project costs are allocated to the line(s) of business to which the project corresponds on a case by case basis.

3.21 The expenses used in setting bonus rates assumed at 30 September 2015 were £53.07 p.a. for premium paying policies; £46.90 p.a. for paid-up policies; and investment management expenses of 0.123% p.a.

3.22 Reversionary bonuses are added annually to the with-profits policies, and are guaranteed additions payable at maturity or on death. On surrender, reversionary bonuses may have value, although it depends on the surrender value basis being used at that time. Reversionary bonuses are declared as a percentage of the sum assured plus previously declared reversionary bonuses. At 30 September 2015, reversionary bonuses were set at 0.5% p.a. for Imperial policies and 4.0% p.a. for Trident policies. The rate declared for Trident policies has been set at 4.0% p.a. for a number of years, but this rate is higher than I would expect to be declared ordinarily in current economic conditions.

3.23 Terminal bonuses are added at the date of a death or maturity claim. Terminal bonuses are normally set annually but may be changed at any time, although such a change is only likely to occur when investment conditions are volatile. Terminal bonuses are expressed as a percentage of the previously declared reversionary bonus attaching to a policy. No terminal bonus is paid on Trident policies.

3.24 Special bonuses were added to Imperial policies which were in force at 31 December 1986. The last such special bonus was declared in 2006, in line with the Scheme governing the merger of Imperial Life and Trident Life. No terminal bonus is paid on Trident policies.

3.25 All of the policies in the SLFC WPF originally issued by Imperial Life have guaranteed surrender values applying to the sum assured. The surrender value of bonuses is not guaranteed.

3.26 The payout on surrender is intended to be the policy's prospective value minus an allowance for the cost of surrender.

3.27 As noted in 2.18, a Prospective Value approach has been adopted in the SLFC WPF to determine bonus rates. This employs the Bonus Reserve Valuation ("BRV") approach rather than an asset share approach. The BRV method is used to derive a bonus scale such that the value of the future benefits applying this scale will be equal to the value of the assets in the SLFC WPF (after also allowing for expenses and profit transfers to shareholders). In determining bonuses, SLOC assumes that corporate bonds will deliver a return equal to 50% of the spread over government (and similar) bonds. The full prospective yield is not used in setting bonus rates since an allowance is appropriate for possible defaults in the corporate bond portfolio and to avoid a declining in-force being unfairly subjected to the variability of experience. To the extent that the allowance is not matched by default experience, any profit or loss would be brought into bonus calculations in the future. Trident policies do not follow this process but have been managed for a number of years with the aim of paying 4.0% p.a. reversionary bonus and no terminal bonus, as noted in 3.22 and 3.23 above. Although the aim is to maintain 4.0% p.a., this reversionary bonus rate is not guaranteed and could be varied in the future, e.g., if the financial position of the SLFC WPF deteriorated such that the interests of other SLFC WPF policyholders were adversely affected by maintaining 4.0% p.a. for Trident policyholders. This demonstrates the common interest in the well-being of the SLFC WPF shared by all its policyholders.

3.28 Although the elements of the bonus scale are set and may be varied independently, SLOC has sought to establish a uniform rate of reversionary bonus which it expects to be sustainable. In practice the current rate for Imperial policies of 0.5% has been used for some time. Allied to this, the shape of the terminal bonus scale has been set on a simple basis increasing linearly with duration in force.

3.29 Figure 4 shows the terminal bonus rates at selected durations applying from 1 April 2016, and also from 1 April 2015, expressed per £100 of reversionary bonus.

Figure 4: Selected terminal bonus rates

Terminal Bonus Rates							
Duration	25	30	35	40	45	50	55
Effective 1 April 2015	293	358	423	489	554	619	684
Effective 1 April 2016	237	290	342	395	448	500	553
2016 bonus as % of 2015 bonus	81%	81%	81%	81%	81%	81%	81%

3.30 Figure 5 indicates the level of investment return assumed in setting bonus rates at recent declarations. This table demonstrates that the base yield used in the calculation has fallen materially in recent years and although a recent widening of the credit spread has occurred, the overall yield has also fallen. Consequent to this the value of the assets of the SLFC WPF have increased in value but correspondingly, the value of the liabilities (particularly, the value of guarantees) has also increased.

Figure 5: interest rate used in BRV calculation

SLFC Assurance UK Bonus Recommendations : derivation of BRV interest rate			
£ millions	**30/09/2013**	**30/09/2014**	**30/09/2015**
Net gilt yield (A)	2.52%	2.31%	1.72%
100% credit spread (B), net of tax	0.39%	0.37%	0.50%
Proportion of credit spread included in BRV interest rate (C)	50%	50%	50%
Gross assumed investment return (A + B x C)	2.72%	2.50%	1.97%
Less net of tax investment and management expenses	-0.13%	-0.12%	-0.14%
BRV interest rate used for bonus recommendation	2.59%	2.38%	1.83%

Source: Sun Life of Canada

Financial Position

3.31 The pro-forma financial position of the SLFC WPF under Solvency II is shown in Figure 6.

Figure 6: SLFC WPF Pro-Forma Financial Position under Solvency II

£million		**31 December 2015**	**31 March 2016**
Assets (less current liabilities)	(a)	**105.8**	**109.2**
Best Estimate Liabilities (“BEL”)	(b)	(105.3)	(108.7)
Risk Margin	(c)	(0.0)	(0.0)
Technical Provisions	(d) = (b) + (c)	**(105.3)**	**(108.7)**
Own Funds	(e) = (a) – (d)	**0.5**	**0.5**
SCR			
- Gross		(7.9)	(8.7)
- Loss Absorbency		7.4	8.2
- **Net**	(f)	**(0.5)**	**(0.5)**
Excess Own Funds	(g) = (e) - (f)	**0.0**	**0.0**

Source: CA Report on the Scheme

3.32 Figure 6 demonstrates that the SLFC WPF was expected to satisfy its own SCR when viewed on a stand-alone basis under Solvency II (and the SLFC WPF would be regarded as a ring-fenced fund for this purpose). The SCR for the SLFC WPF is relatively small since the nature of with-profits business is such that adverse experience is absorbed by the policyholders' fund. The scale of this loss absorbency is indicative of the risks borne by the SLFC WPF policyholders and which may affect their future policy benefits.

3.33 Figure 7 demonstrates the variation in net assets and the resulting variation in the terminal bonus cushion in recent years on the basis used in setting bonuses. The terminal bonus cushion has been relatively consistent from 2013 to 2015. It is clear from Figure 7 that there is a reasonable level of terminal bonus cushion (of approximately 25% of the BRV value) which potentially gives solvency relief if there is adverse experience.

Figure 7: Robustness of SLFC WPF Bonus Recommendations

	Effective date of terminal bonus recommendation *		
£ millions	**30/09/2013**	**30/09/2014**	**30/09/2015**
Assets (net of current realistic liabilities)	119.80	121.40	110.70
Less			
Regulatory Peak Reserve**	5.40	5.90	0.00
Current liabilities	4.70	6.10	-2.30
Reserve for anticipated changes in surrender value parameters	1.40	N/A	N/A
Cost of Conversion	N/A	N/A	-0.50
Distributable assets (Total Bonus Reserve Valuation)	**109.70**	**109.40**	**107.90**
Terminal bonus cushion as % of total BRV	24%	23%	25%
Reversionary bonus cushion as % of total BRV	7%	5%	5%
BRV no bonus / total BRV	69%	71%	69%

Source: SLOC CA

*The financial data used to set the bonus is at 30 September in the previous year, so the final column shows the impact of the bonus declaration in the following April.

** The Regulatory Peak Reserve relates to the non-profit business which was transferred to the Non-Profit Fund in 2015.

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4. OUTLINE OF THE SCHEME

Reasons for the Scheme

4.1 Although SLOC does not consider that there is an immediate need to promote a Scheme to wind up the SLFC WPF, it considers that, in time, the SLFC WPF will become unviable to continue as a separate entity due to its relatively small size and the existence of settlement options which could result in an inequitable allocation of costs to SLFC WPF policyholders. Without conversion, as the SLFC WPF decreases in size, SLOC expects that managing the volatility in payouts will become more difficult. Additionally, that the costs of implementing conversion are largely fixed and so would weigh more heavily on the diminishing number of policyholders in the future. Furthermore, the implementation of Solvency II may constrain the SLFC WPF investment strategy due to the capital requirements related to it; this may reduce future bonus expectations (see 5.8 – 5.9 for further commentary on this).

4.2 SLOC currently subsidises the expenses charged to the SLFC WPF by approximately £0.1 million currently, and converting now will lock this subsidy into policyholder benefits. SLOC will gain a slight reduction in expenses by not having to maintain the SLFC WPF.

4.3 The Scheme is to effect an orderly winding up of the SLFC WPF by converting the policies in the SLFC WPF into non-profit policies. The SLFC WPF will cease to exist after the Scheme becomes effective. It is proposed that policy benefits will be subject to a scale of fixed increases in the future to remove any volatility that could apply to the benefit payments due to bonus rates which may otherwise vary in the future post-conversion.

Effective Date

4.4 The Effective Date of the Scheme, subject to Court approval, is expected to be 1 February 2017.

Procedure

4.5 The policyholders of the SLFC WPF will be invited to vote on the terms of the Scheme and, subject to the approval of the Court, the result will be binding on those policyholders as a class.

4.6 Before the Scheme can be presented to the Court for approval, more than 50% of policyholders who vote must vote for the proposal and those policyholders must be entitled to at least 75% of the value voted.

4.7 For the purpose of the Scheme, the value for each policy will be the prospective value of the future benefits on the bonus setting basis as at 30 June 2016.

Terms of the Scheme

4.8 On the Effective Date, each with-profits policy in the SLFC WPF will be converted to a non-profit policy by means of an endorsement to the policy's terms and conditions.

4.9 Each replacement non-profit policy will have the same sum assured, special bonuses and accrued reversionary bonus as prior to conversion.

4.10 Following conversion, the accrued reversionary bonus will be enhanced at a rate guaranteed for the remaining duration of the policy. For Imperial policies, this rate will be 0.5% p.a. and for Trident policies it will be 4.0% p.a. The guaranteed annual increase will occur on the policy anniversary.

4.11 On a claim by death or maturity, an uplift, the Guaranteed Final Increase ("GFI") (analogous to terminal bonus), will be applied to Imperial policies from the Final Implementation Date, expected to be 1 April 2017. No uplift will apply to Trident policies. In the period between the Effective Date and the Final Implementation Date, the GFI rates will equal the rates of terminal bonus that would apply then in the absence of the Scheme (i.e., the bonus rates which became effective as at 1 April 2016 in line with SLOC's current practices).

4.12 From 1 April 2017, the GFI at each policy duration will increase annually at guaranteed rates. The calculation of these guaranteed rates of increase will be undertaken as at the Effective Date on the basis laid out in the following paragraphs. The first increase will apply as at 1 April 2018.

4.13 SLOC will initially calculate the rate of increase of the GFI factors under the basis applying pre-conversion (i.e., allowing for 50% of the spread on corporate bonds). This is given by a table differentiated by duration. Longer duration policies have higher rates of GFI, and so the table includes allowance for future increases in the GFI factors. The rates are set so that the surplus of the SLOC WPF, allowing for the cost of bonuses, is zero (i.e., the expected policy values will equal the adjusted value of the assets, such adjustment being in line with 4.16 below). The expenses used in the calculation to determine replacement benefits will, for direct expenses, be in line with expenses charged by the outsourcers, inflating at RPI +1% p.a., plus overhead expenses of £20.40 per policy, increasing from 2015 at RPI +3.5% p.a.

4.14 SLOC will then calculate the surplus using the initial scale of GFI factors determined as in 4.13 but using the post-conversion assumptions. The key differences to the pre-conversion assumptions arise in the discount rate used to effect the calculation:

- Investment return: the post-conversion assumption is that all assets are government (or similar) bonds and therefore the post-conversion investment return assumption is risk-free. The discount rate will be derived from the gilt yield curve and will be increased by 8 bps to reflect the expected enhanced returns over gilts which SLOC will earn from limited investment in non-gilt assets related to the post-conversion business.
- A charge for the cost of capital: this reflects that the Solvency II capital requirement is likely to be higher post-conversion as non-profit business than it would be if continuing as with-profits business due to the higher levels of guarantees in non-profit contracts. This capital will be provided by SLOC's shareholder. The charge for the cost of capital has been assessed as an 11 bps reduction to the assumed investment return described in the previous bullet point. This charge is the equivalent of an 11% required return on capital less the expected earnings on the capital held and based on the amount of such capital being 150% of the Solvency II SCR for the SLFC WPF policies post-conversion.
- A deduction of 3 bps for costs incurred in transitioning the assets of the SLFC WPF to government (or similar) bonds (to the extent necessary at the Effective Date).
- The allowance for with-profits governance costs in the pre-conversion calculation (4 bps p.a.) will be excluded.

4.15 In both the pre-conversion and post-conversion calculations, investment expenses of 10 bps will be applied by reducing the relevant yield.

4.16 The asset value of the SLFC WPF will be adjusted to allow for:

- Conversion costs: All direct costs will be charged to the SLFC WPF but these will be capped at £600,000 (including VAT). The costs will be subject to tax relief of 20%. A contribution of £50,000 (net of tax relief) will be made from the SLFC WPF to cover SLOC's internal costs in implementing the Scheme;
- The shareholder's share of future profits; and,
- The reserve for settlement options, the liability for which will be met by the shareholder post-conversion.

4.17 SLOC will repeat the calculation in 4.14 using post-conversion investment return assumptions, but will set the future GFI factors such that there is no increase to the GFI factors for 25 years but thereafter the increase will follow the rates of increase determined in 4.13. This will determine the surplus available.

4.18 The result of the surplus calculation in 4.14 is expected to be negative while that under 4.17 is expected to be positive. SLOC will interpolate between the two results to determine a rate of increase to apply for the first 25 years such that the surplus expected will be zero. The rate of increase 25 years from the Effective Date will equal the rate found in 4.13. This gives the scale of uplift factors which will apply post-conversion.

4.19 The application of this calculation will result in benefits lower than may have applied had the SLFC WPF continued to be maintained. The Scheme provides a protection on the level of the reduction by limiting it to be less than a specified proportion of the projected claim value determined for groups of policies as at the Effective Date, using the current bonus setting methods and assumptions. The maximum reduction which will apply will be set at 10% for policies becoming claims at a date 25 years after the Effective Date, tapering down to no reduction on policies becoming claims immediately after the Effective Date. The cost of applying this limit, if it bites, will be met by the Non-Profit Fund.

4.20 Since the calculations to be undertaken as described in 4.13, 4.14 and 4.17 are sensitive to the expected returns on the assets held, if SLOC takes steps to de-risk the assets held in the SLFC WPF (and hence reduces the expected returns) below the range set out in the PPFM, the returns used in the calculations will be derived from the assets held on the date upon which de-risking commences.

4.21 The calculations to be undertaken to determine the GFI rates will be reviewed by the WPA who will also agree the GFI rates to be applied.

4.22 Surrender values will be set to reflect the value of the policies (equivalent to the discounted value of benefits) but subject to any guaranteed minimum values on the policy.

5. THE FINANCIAL TERMS OFFERED TO POLICYHOLDERS OF THE SLFC WPF

Approach

5.1 In this section of the Scheme Report, I consider the terms of the Scheme and the consequential effects of the Scheme on the policyholders of the SLFC WPF after implementation of the Scheme.

5.2 I have had regard to the relevant sections of the PRA Rulebook and the FCA Handbook, specifically PRIN[4] and the requirements of COBS 20[5], in conducting this assessment.

5.3 In this section I consider the fairness of the terms of the financial arrangements being offered to the SLFC WPF policyholders under the Scheme, and in particular:

- Desirability of the Scheme;
- The impact of asset allocation;
- The proposed benefit of the non-profit policy post-conversion;
- The impact of guarantees and options;
- The impact of charges;
- The impact of smoothing; and,
- The consequences of the Scheme not proceeding.

Desirability of the Scheme

5.4 The principal aim of the Scheme is to achieve a more stable position for the benefits payable to the SLFC WPF with-profits policyholders than may apply in the future under the current structure.

5.5 The SLFC WPF must be managed currently in line with its PPFM. Management is also subject to the requirements of the agreed run-off plan. The PPFM and the run-off plan impose a number of aims but these may also act as potential constraints on achieving a satisfactory outcome.

5.6 The PPFM require that SLFC WPF is to be managed currently having regard to its own resources and is expected to meet its liabilities including expenses without recourse to any other funds. It is also expected to pool experience and to impose smoothing on policyholder benefits. Benefits are determined having regard to the requirement to distribute all of the assets of the SLFC WPF to SLFC WPF policyholders. The benefits are influenced by the intention that residual policyholders in the SLFC WPF should not be exposed to enhanced risks as the quantum of the fund reduces. Each of these aims will become more difficult to achieve as the SLFC WPF shrinks:

- a smaller in-force population over which to spread the impact of adverse experience;
- a smaller capital base in the SLFC WPF to act as a first point of call to cover adverse experience; and,
- in the longer term, the challenge of managing a sufficiently diversified asset mix.

5.7 Although the SLFC WPF is to be managed in the way described above which anticipates that there will be no recourse to other assets, in extremis, there could be "burn-through" costs if the assets in the SLFC WPF became insufficient to meet guaranteed payments (e.g., if the capital of the SLFC WPF had been distributed too quickly). Consequently, in the absence of the Scheme, there could be an incentive for shareholders to apply a cautious approach in the management of the SLFC WPF, which may produce a tontine effect (whereby the final policyholders remaining in the SLFC WPF may benefit unduly from a pool of capital retained in the

[4] Principle 6 ("Customers' interests") set out in PRIN 2.1.1 of the FCA's Principles of Business ("PRIN") states that "A firm must pay due regard to the interests of its customers and treat them fairly."

[5] Chapter 20 of the FCA's Conduct of Business Sourcebook covers the regulatory requirements to be adhered to by firms carrying on with-profits business.

fund but not eventually required). However, I note that a considerable buffer for terminal bonuses exists and I would not expect the burn-through risk to warrant such an approach.

5.8 The investment strategy adopted must have regard to both the amount of the capital and the potential financial impact on the SLFC WPF, striking a balance between the desire to maximise returns but avoiding conflicts between different generations of policyholders. The amount of capital required to be held is an indication of the downside risk for policyholders. Although the capital required may be set according to internal risk appetite policies, Solvency II sets standard rules for determining the amount of the capital required and this may influence the investment strategy of the SLFC WPF since the amount of capital required to be held increases with the exposure to credit risks (such as those inherent in the current corporate bond holdings of the SLFC WPF). Although the capital requirement is in effect met from the bonus buffers in the SLFC WPF, the amount of the offset does indicate the risk to which the benefits are exposed on the occurrence of an extreme event. This is demonstrated by the amount of the loss absorbency shown in Figure 8 below.

Figure 8: Pro-forma Solvency II Position of the SLFC WPF as at 31 March 2016

		£ million
Assets (less current liabilities)		109.2
Best Estimate Liabilities ("BEL")	(108.7)	
Risk Margin	(0.0)	
Technical Provisions		(108.7)
Own Funds		0.5
SCR - Gross - Loss Absorbency - Net	 (8.7) 8.2 	 (0.5)
Excess Own Funds		0.0

Source: CA report on the Scheme

5.9 The PPFM does not specify a target for this exposure but effectively requires it to be set consistently with the available financial resources of the SLFC WPF and the capital required to provide for the risks related to this investment strategy. As noted in 3.18, the exposure to corporate bonds has been reduced over the last two years from approximately 45% to 37% of the assets held. The transition to the current level has been conducted under the current investment guidelines and reflects recent investment markets and investment decisions, and is independent of the implementation of the Scheme. I expect that the exposure to corporate bonds will reduce further in the future. Removing corporate bonds entirely from the portfolio would have the effect of reducing the yield used to set bonuses by approximately 18 bps (i.e., 0.18% pa) as at 31 March 2016, which is broadly the same effect as will arise on implementing the Scheme, see Figure 9, below.

5.10 The SLFC WPF is subject to the risks related to the settlement options, which give policyholders valuable guarantees. Take-up rates have historically been very low, even in the current ultra-low yield environment but have shown a significant increase since 2013 and are now at around 14% for maturing endowment policies (see 3.9). If a further increase to take-up rates occurred, then there would be a potential increase in cost to be met by the SLFC WPF. In particular, If policyholders begin to exercise the option on whole of life policies or the pattern of exercising the option changed (e.g., Option E is estimated to cost 10 times that of the next most costly option), then the burden could increase quite substantially.

5.11 The reserves held to cover the settlement options are £0.4 million, approximately, and this value is used in the determination of bonus rates. Therefore, the effect of an increase in take-up rates may be unlikely to have a material impact on the apparent solvency position of the SLFC WPF (on a standalone basis). However, such an increase could have a significant impact on policyholders' benefits in the future: since the fund would be reduced by the additional cost incurred from prior claimants exercising the settlement option, so that bonus prospects would be reduced for SLFC WPF policyholders then remaining in force. This demonstrates a potential conflict of interests between those exercising the option at exit and those remaining in the SLFC WPF. The Scheme will remove this risk.

5.12 On transfer of the policies to the Non-Profit Fund, settlement options will remain intact in exchange for an "insurance" premium paid from the SLFC WPF to the Non-Profit Fund.

5.13 Maintaining the separate fund structure and the PPFM as well as having the required governance and oversight functions introduce overhead costs which ultimately may have to be met by the SLFC WPF and its policyholders, and these, inevitably, have to be spread over the smaller in-force population.

5.14 Having considered these points in the round, if no action is taken to address these issues, then the future management of the SLFC WPF in line with its PPFM could become difficult and outcomes for policyholders may become much more uncertain.

5.15 From the foregoing, it is clear that I consider there are many benefits in implementing a scheme. However, I note that that there could be disadvantages in affecting the Scheme now. In particular, the Scheme will lock policyholders into the set of circumstances as at the Final Implementation Date and will remove the possibility of any upside benefit thereafter. I have considered where, and the extent to which, upside benefits may emerge. In my view, these are:

- Investment returns being better than anticipated by the Scheme: as discussed above, I would expect that a greater exposure to lower yielding gilts is more likely in the future than an increase in higher yielding corporate bond holdings as the fund runs off; and,
- The approach to setting bonuses only allows for 50% of the credit spread in corporate bonds held: at present, any deviation in the default experience relative to this assumption (positive or negative) falls to the SLFC WPF. Having regard to published analyses of the components credit spreads, I do not consider the assumption of 50% unreasonable for this purpose in the context of high quality corporate bonds. In any event, this point has lesser impact than it may have had since the observed credit spreads are narrower currently and the exposure to corporate bonds reduced.

5.16 In my opinion, it will be desirable to take action to convert the with-profits policies in the SLFC WPF to non-profit and transfer the business to the Non-Profit Fund to ensure a fair and orderly distribution. Given the currently low credit spreads, the rapid decline expected in the SLFC WPF, the relatively fixed cost of implementing a scheme such as this, and the likely need to reduce the exposure to corporate bonds in the future, it is reasonable to take such action now.

Proposed benefits post-conversion

5.17 Under the terms of the Scheme, the SLFC WPF policies will become non-profit and future benefits will be determined on the basis of a fixed annual rate of increase and a fixed scale of GFI factors to apply to claims. Both elements will apply in the same way that reversionary bonuses and terminal bonus do currently. For Trident policies a fixed annual rate of increase of 4.0% p.a. will apply, but there will be no GFI factor (reflecting the fact that no terminal bonus is paid on these contracts). The Scheme removes the possibility of the 4.0% p.a. reversionary bonus rate being reduced in the future. Since 4.0% p.a. reversionary bonus is higher than I would expect to be declared ordinarily in current economic conditions, the effect of the Scheme is beneficial to Trident policyholders since it will guarantee this rate in the future.

5.18 All contractual rights under the SLFC WPF policies will be maintained unaltered. The right to exercise settlement options will continue and guaranteed surrender values will be honoured.

5.19 Surrender values in the future will be derived from the guaranteed benefits arising under the application of the GFI rates.

5.20 In my opinion, the amended structure being proposed for the SLFC WPF policies is appropriate to achieve the aims of the Scheme and provides for the rights of policyholders.

Methodology and assumptions to determine the new benefit scale

5.21 Having considered the desirability of implementing the Scheme and the appropriateness of the amended policies, I now consider the financial aspects of the terms of the conversion. I will consider the following elements:

- The derivation of the discount rate to be used;
- The initial adjustment for Scheme costs;
- The expenses to be applied in the future;
- The “premium” to be paid to the Non-Profit Fund in respect of the settlement options; and,

- The methodology of the calculation.

Derivation of the discount rate

5.22 As noted in Section 3, the SLFC WPF currently invests in a diversified portfolio of corporate bonds and UK Government bonds. Corporate bonds have a higher expected return than UK Government bonds, although the return is more volatile and there is a greater risk of losses. However, at present, the spread between the yield on good quality corporate bonds and government debt (which comprise the larger part of the SLFC WPF assets currently) has narrowed from levels seen historically and there is an opportunity to lock-in the consequential capital gains by implementing the Scheme.

5.23 Post-conversion, the levels of guarantees under the SLFC WPF will be much greater and the risk related to these guarantees will be borne by the Non-Profit Fund. Assuming the current investment approach post-conversion (i.e., using corporate bonds at the current level of exposure) would have a capital impact in the Non-Profit Fund and there is a cost related to holding additional capital for which the Non-Profit Fund would require to be compensated. SLOC has investigated the impact of maintaining the current investment mix post-conversion, and believes that the expected higher cost of capital from investing in corporate bonds outweighs the expected higher return. Consequently, it is intended that SLOC will hold government debt (or similar high quality, low-risk) assets in the Non-Profit Fund post-conversion and that this asset class will be used to determine the benefits post-conversion. Broadly, the impact of this investment mix will be that the post-conversion terms will be derived from a risk free yield curve. There will also be various adjustments made to the risk free rate.

5.24 First, the investments to be employed in the Non-Profit Fund may include non-UK government stocks, such as those issued by supranational bodies, which are high quality but may provide a higher yield. An allowance of an 8 bps increase to the post-conversion risk free yield will be made for this. While the proportion of the assets which may fall into this category has not been set and the uplift which the Non-Profit Fund may achieve will depend on future circumstances, I consider that the proposed fixed uplift is reasonable reflecting the modest yield increase available in supranational bond holdings.

5.25 Secondly, there will be an adjustment to reflect the cost of the capital which will have to be allocated in the Non-Profit Fund to cover the post-conversion benefits. At present, the SLFC WPF meets its own capital requirements and is able to do so because of the nature of the existing with-profits contracts, where bonuses can be reduced to mitigate adverse experience. Post-conversion, the benefits under the SLFC WPF policies will be fully guaranteed and, as such, they will be subject to higher Solvency II capital requirements and this must be met by capital in the Non-Profit Fund. I consider it appropriate that an adjustment is made for the cost of capital with the advantage to SLFC WPF policyholders being that they benefit from the enhanced guarantees and reduced risks in the future.

5.26 The adjustment for the cost of capital is the reduction required to achieve an 11% return on the marginal amount of capital required to be applied in the Non-Profit Fund as a result of the Scheme being implemented. The amount of capital is based on Solvency II capital requirements, uplifted by SLOC's risk appetite (150% of capital requirement) but reduced by the amount that will be credited to the Non-Profit Fund on implementation of the Scheme as its share of future distributed surplus (i.e., the cost will be based on the amount of capital needed to be "raised" by the Non-Profit Fund to cover the post-conversion SLFC WPF policy benefits). This results in an 11 bps p.a. reduction to the assumed investment return. I consider the assumptions and the method used to derive this adjustment to be reasonable.

5.27 Thirdly, investment management expenses of 10 bps pa (net of tax) will be deducted. This adjustment reflects the impact of the current investment arrangements and is in line with the rate currently applied in managing the SLFC WPF's assets.

5.28 There will also be an adjustment of 3 bps pa in respect of any corporate bond assets held at the Effective Date to reflect the dealing spread in switching to government bonds. The quantum of this adjustment is reasonable but it will only apply to the extent that the investment transition has not been completed by the Effective Date.

5.29 Figure 9 indicates the impact of these adjustments had the Effective Date been 31 March 2016.

Figure 9: Impact of conversion on assumed investment returns

	Bonus setting basis	Conversion Basis	Impact of Conversion
Assumed Gilt Yield	1.61%	1.61%	-
Assumed Corporate Bond Spread	0.35%	-	
Proportion of spread allowed	50%	n/a	
Assumed uplift	0.18%	0.08%	-0.10%
Deduction for cost of capital	n/a	-0.11%	-0.11%
Asset transition cost	n/a	-0.03%	-0.03%
Allowance for WP Governance costs	-0.04%	-	+0.04%
Rate of Return	**1.75%**	**1.55%**	**-0.20%**
Investment expenses	-0.10%	-0.10%	-
Effective Rate of Return	**1.65%**	**1.45%**	**-0.20%**

Source: CA Report

5.30 Figure 9 demonstrates that the discount rate used to determine the post-conversion benefits would have been 20 bps lower than the rate used for bonus setting purposes currently. As shown in Figure 9, this comparison allows for the offset saving from not having the governance costs of a with-profits fund, which have been valued at 4 bps pa. If investment conditions are appropriate (and assuming that policyholders have consented to the Scheme), SLOC may decide to switch the investment portfolio shortly before the Effective Date to reflect the investment strategy which it will apply post-conversion (see 5.23). If this action is taken then, without further action being taken, the bonus setting yield would be artificially lowered. To avoid this effect, the corporate bond spread on the SLFC WPF on the date on which the decision to switch is taken will be substituted. Since this action is likely to be taken shortly before the Effective Date, I do not consider that it will produce an adverse result for SLFC WPF policyholders. The SLFC WPF will not be charged any transition costs (see 5.28) in these circumstances.

5.31 I have also been provided with a comparison of the Effective Rate of Return that would apply on the basis that the current corporate bond portfolio was transferred from the SLFC WPF to the Non-Profit Fund and used as the basis for the conversion calculations. On this basis, the amount of capital required in the Non-Profit Fund would increase significantly as would the charge required to compensate it. The deduction for the cost of capital has been estimated to increase from 11 bps (as anticipated by the Scheme) to 54 bps p.a. which would more than offset the expected higher return to be earned from corporate bonds. I have considered the detail of this calculation and agree with the conclusions of this assessment.

5.32 In my opinion, the basis for determining the discount rate to be used in setting the post-conversion benefits is reasonable.

Initial adjustment for Scheme costs

5.33 External costs incurred by SLOC in implementing the Scheme will be charged to the SLFC WPF assets but will be capped at £600,000 (including VAT). This amount will be tax relievable and will be netted down in the post-conversion calculations. A net contribution of £50,000 for SLOC's costs will also be made. This latter amount is net of tax and VAT.

5.34 I consider it reasonable that the SLFC WPF should make a contribution to the costs of developing and implementing the Scheme which is aimed at protecting the interests of its policyholders. The cap placed on the external costs allocated serves as a protection.

5.35 The contribution in respect of internal costs is modest and the actual cost of the time spent is very likely to be far greater than £50,000. External costs are considerably more than £600,000 and the excess has been met from SLOC's shareholder assets.

5.36 In my opinion, the initial adjustment for Scheme costs is reasonable and appropriate.

Impact of expenses

5.37 The expense assumptions to be used in the calculations will be those in line with the expenses charged to the SLFC WPF currently (which for the avoidance of doubt, reflects an increased allowance for inflation which applies from 2015). The expense assumption is effectively neutral but it is noted that the amounts currently charged to the SLFC WPF are not the full amounts incurred by SLOC, which has reduced these on a discretionary basis. The Scheme therefore locks-in the benefit of the current discretionary arrangement which is likely to be beneficial to SLFC WPF policyholders.

Impact of guarantees and options

5.38 The Scheme will preserve the guarantees and options embedded in the SLFC WPF policies, in particular, the settlement options will be preserved. The liability for these options will in future be met by the Non-Profit Fund rather than being a risk borne by the SLFC WPF policyholders. It is to the benefit of the SLFC WPF policyholders to be free of this risk, as noted in 5.11.

5.39 In compensation for the Non-Profit Fund taking on this liability, the amount assessed in the SLFC WPF to be the realistic estimated cost of the settlement options will be transferred to the Non-Profit Fund. This amount will be determined on the basis used in bonus setting for the SLFC WPF (namely on a Canadian IFRS basis). The amount in question is likely to be £0.4 million approximately, but as noted previously, this could be materially less than the burden from even a modest upturn in the rate at which these options are exercised.

5.40 The amount of the “premium” that the SLFC WPF will pay to the Non-Profit Fund is neutral in its immediate impact on benefits in the context of the conversion calculations since it is equal to the provision used in bonus setting. While an element of judgement may be expected to apply in setting the appropriate provision within the SLFC WPF for this risk, I do not consider that using this amount to determine the premium to be paid is unreasonable.

5.41 The amount of the premium is not material in the context of the current in-force business of the SLFC WPF given the downside potential for future claims (see 5.10-5.11). The annual cost of the settlement options was approximately £50,000 in each of 2014 and 2015, and the whole of the cost related to endowment assurance claims. The annual cost is sensitive to both the take-up rate and the option chosen. As noted in 3.9, the take-up rate has increased materially already in recent years and the cost of certain of the options is very much greater than the options more frequently chosen in the past.

5.42 The position is clearly subjective since it is dependent upon on policyholder behaviour which is impossible to predict but I consider that the amount of the premium could very easily be overtaken by cost of the options. In the SLFC WPF currently, the cost of this risk is borne by policyholders who remain in the fund.

5.43 On the balance of probabilities, the arrangement is more likely to be beneficial overall to the SLFC WPF policyholders. Accordingly, I do not consider it necessary to introduce any arrangements to monitor the profits or losses which may arise in the Non-Profit Fund from settlement options.

5.44 In my opinion, the proposed arrangements for meeting the cost of the settlement options is fair and reasonable to the SLFC WPF policyholders.

The methodology to be used

5.45 The methodology which is to be used is based on the methodology used to set bonuses in the SLFC WPF. The calculations determine, first, the bonus rates applicable in the pre-conversion structure. In practice the annual reversionary bonus rate is assumed to be fixed at its current rate and the GFI factors (which will equal the terminal bonus rates) are solved for. A feature of the terminal bonus structure is that the GFI factor derived for any given year of entry will increase with the passage of time. The GFI factors will be lower post-conversion than pre-conversion and it is necessary to establish a scale which does not introduce a material discontinuity for claims in the near future and aligns with the structure of the current terminal bonus scale. To determine the future increases to the GFI factors, the calculations will be re-done using the post-conversion assumptions to determine a scale for the GFI factors. This is achieved by smoothing the annual increases to the GFI factors over a period of 25 years.

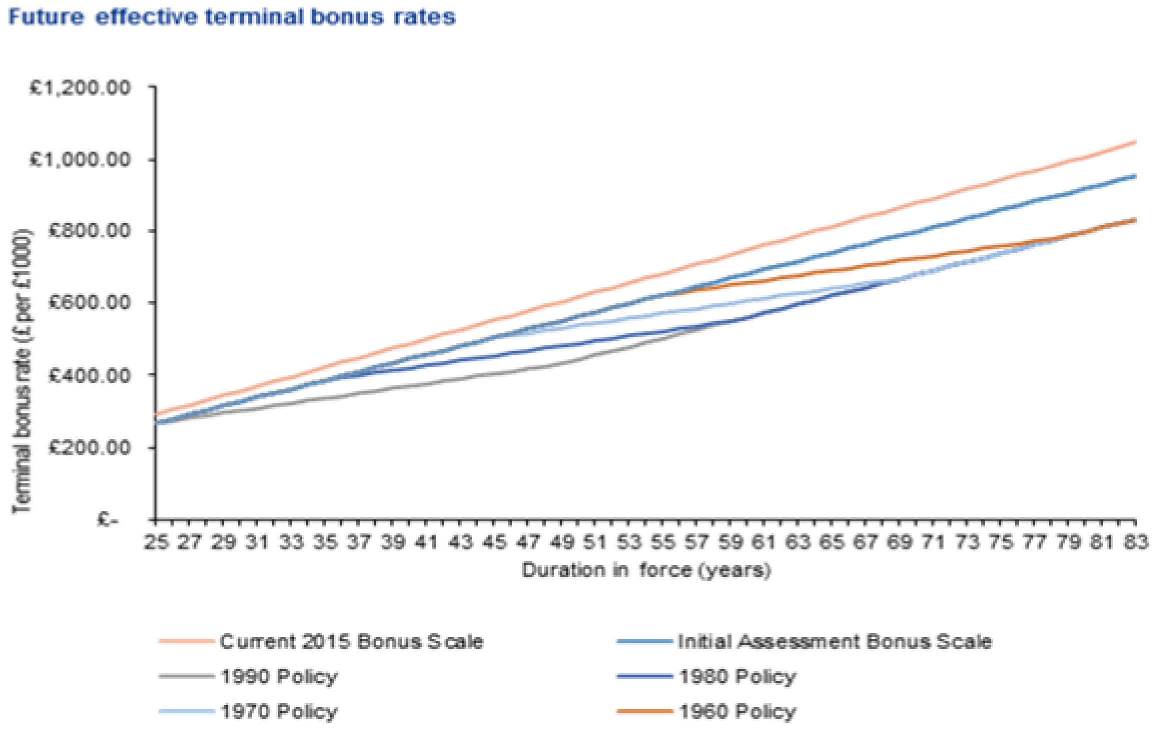
5.46 The effect is further constrained so that no policy value will be more than 10% lower than would have been achieved from the bonus scale derived under the current with-profits regime as at the Effective Date.

5.47 This method does change the shape of the GFI factors relative to the terminal bonus scale but is aimed at mitigating the impact of the conversion on longer term policyholders. The effect is complex but is demonstrated further below.

5.48 The GFI factors are subject to the constraint that the resulting claims amounts at any date in the future should be not be more than 10% lower than an amount derived from calculations to be undertaken on the bonus setting basis as at the Effective Date. The comparison will be undertaken on a basis which groups similar contracts together (e.g., by duration and/or year of entry). This is consistent with the way in which bonuses are currently derived.

5.49 Figure 10 illustrates the anticipated impact on the GFI factors. In this chart, the top curve shows the terminal bonus scale in-force at April 2015, where terminal bonus is expressed in per £1,000 of reversionary bonus. The blue line immediately below the April 2015 terminal bonus scale shows the uplift which would apply applying the pre-conversion basis. The remaining lines show the bonus scales for different years of entry on the post conversion basis. For example, the 1990 entry has lower bonuses at all durations. At duration 50 (25 years after the Effective Date), the rate of increase in the GFI factor reflects the rate from the initial calculation, and the line becomes parallel to the Initial Assessment Bonus Scale represented by the second line from the top. Although Figure 10 demonstrates the effect as at April 2015, it is representative of the effect of the impact of the Scheme at any given effective date.

Figure 10: Illustrative impact on the uplift factor



5.50 The following table demonstrates how the current benefits for some specimen polices may be affected by the application of the Scheme. The table shows:

- The guaranteed benefits at the conversion date, which will be unaltered;
- The possible claim value at various dates in the future, calculated on the current bonus setting approach, but which will not be guaranteed;
- The guaranteed claim value which will apply on those future dates if the Scheme is implemented;

- The difference in the claim values arises from the possible terminal bonus addition being greater than the amount added by the GFI; and,
- The percentage reduction in benefit builds up relatively slowly and would remain less than the cap which has been set, even 25 years after the Scheme has become effective (at which point, less than 20% of current policies will still be in force).

Specimen Policy		2	2	2	3	3	3
Year of Issue		**1975**	**1975**	**1975**	**1965**	**1965**	**1965**
Assumed Year of Claim		**2026**	**2036**	**2041**	**2026**	**2036**	**2041**
Guaranteed Benefits at conversion date	Sum Assured	£5,260	£5,260	£5,260	£2,750	£2,750	£2,750
	Special Bonuses	£340	£340	£340	£230	£230	£230
	Accr'd Reversionary Bonus	£6,048	£6,048	£6,048	£4,792	£4,792	£4,792
	Total	**£11,648**	**£11,648**	**£11,648**	**£7,772**	**£7,772**	**£7,772**
Bonus setting basis (Terminal bonuses as Appendix A, Table 1)	Future Reversionary Bonus	£578	£1,186	£1,825	£386	£791	£1,217
	Terminal bonus	£2,829	£3,726	£3,897	£2,667	£3,367	£3,534
	Total payout	**£15,055**	**£16,560**	**£17,370**	**£10,825**	**£11,930**	**£12,523**
Conversion basis (Terminal bonuses as Appendix A, Table 3)	Future Reversionary Bonuses	£578	£1,186	£1,502	£386	£791	£1,002
	Terminal bonus	£2,511	£3,024	£3,307	£2,418	£2,831	£3,048
	Total payout	**£14,737**	**£15,858**	**£16,457**	**£10,576**	**£11,394**	**£11,822**
Impact of TB increments		-£318	-£702	-£913	-£249	-£536	-£701
Percentage impact		**-2.1%**	**-4.2%**	**-5.3%**	**-2.3%**	**-4.5%**	**-5.6%**

Source: CA Report on the Scheme

5.51 The Scheme limits the reduction in payouts 25 years after the Effective Date to be not more than 10% of that which would have been achieved on the bonus scale as at the Effective Date. A sliding scale applies from the Effective Date to 25 years thereafter. SLOC has set this cap on the advice of the With-Profits Committee and the WPA. The cap of 10% has been set pragmatically but it does reflect a widely used industry practice in aiming to set with-profits payouts so that that they will normally lie within 10% of the asset share value. Additionally, 10% is applied as an annual limit in operating smoothing in the SLOC WPF. SLOC also applied a limit (but expressed differently) in the recent wind-up of another of its with-profits funds, and this ensures consistency in its general approach. However, I also note that had the Scheme been implemented as at 31 March 2016, the reduction in payouts relative to the current bonus scales would have been much less than 10% (see Figure 10 in 5.49). In this regard, the limit serves as protection against credit spreads widening before the Final Implementation Date. I consider a 10% limit to offer a reasonable level of protection

5.52 The trade-off for policyholders is that there will be certainty of outcome in implementing the Scheme. However, in the absence of the Scheme, I would anticipate that a more risk averse investment strategy may be needed in the future which would result in relatively lower future returns than have been earned in the past, which will impact on benefits in the future

5.53 I consider that the methodology achieves a fair and balanced outcome for SLFC WPF with-profits policyholders.

Consequences of the Scheme not proceeding

5.54 In the event that the Scheme does not proceed, SLOC will continue to operate as it currently does and will maintain the SLFC WPF. The SLFC WPF policyholders will continue to be exposed to the risks outlined in Section 3 of this Scheme Report.

5.55 The costs incurred in developing the current Scheme (subject to the caps described in 5.33) will nonetheless be met from the SLFC WPF. In the event that a scheme is required at some time in the future, all of the costs incurred would potentially be levied on the SLFC WPF at that time. Furthermore, I note that SLOC does not plan to make any provision within the next five years for a future scheme, which ultimately means that policyholders exiting the SLFC WPF before then would make no contribution to a future scheme's cost.

Conclusion on the effect of the Scheme on SLFC WPF policyholders

5.56 The Scheme aims to achieve an orderly winding up of the SLFC WPF and, in my opinion, it achieves that aim in a fair and balanced manner. In terms of the effect that the terms being proposed will have on the benefits of the SLFC WPF policyholders, the expected benefits post-conversion will be lower than the benefits derived on the current bonus scale. The trade-off for policyholders is that benefits will be guaranteed post-conversion and they are not exposed to the risks associated with managing a fund in run-off. Most importantly, they will not be exposed to the risks from the settlement options (but will still enjoy, and benefit from, their availability).

5.57 On balance, I consider that the certainty delivered by implementing the Scheme outweighs any advantage that may be derived from maintaining the SLFC WPF.

6. SECURITY OF BENEFITS

6.1 Since the changes proposed by the Scheme are all contained within SLOC and the SLFC WPF is relatively small, it would be expected that the overall position after implementing the Scheme would be minor. In practice, the Scheme only affects the SLFC WPF and the Non-Profit Fund directly.

6.2 Since the Scheme will become effective under the Solvency II regime, considering the effects of the Scheme on the solvency position under the previous regulatory regime (upon which the last published figures were based) will not provide the relevant standard of comfort on security. Although I have considered the effect on solvency under the previous regime (which is trivial), the discussion which follows addresses the Solvency II position only.

6.3 Figure 11 shows the impact of the conversion on solvency in the Non-Profit Fund under Solvency II as at 31 March 2016, assuming that a government bond strategy is followed post-conversion. (In the absence of the Scheme, the SLOC WPF and the SLFC WPF will be treated as ring-fenced funds under Solvency II, and the table only shows the relevant capital requirement (SCR) and capital available to cover it ("Own Funds") for each fund rather than their detailed assets and liabilities.)

Figure 11: Pro-forma Solvency II Capital Position at 31 March 2016

	Pre Conversion £ million		Post Conversion £ million	
Assets (less current liabilities)		**7,186.2**		**7,295.4**
Non-Profit Fund				
- Best Estimate Liabilities	(6,488.9)		(6,598.1)	
- Risk Margin	(116.4)		(117.7)	
Technical Provisions		**(6,605.3)**		**(6,715.8)**
Eligible Own Funds ("EOF")				
- Non-Profit Fund		580.8		582.1
- SLOC WPF	3.0		3.0	
- SLFC WPF	0.5		n/a	
Total EOF		**584.3**		**585.1**
SCR				
- Non-Profit Fund	(285.9)		(288.9)	
- SLOC WPF	(3.0)		(3.0)	
- SLFC WPF	(0.5)		n/a	
Total SCR		**(289.4)**		**(291.9)**
Excess Own Funds = Total EOF – Total SCR		**294.9**		**293.2**
Solvency Ratio = Total EOF / Total SCR * 100%		**202%**		**200%**
Proposed dividend		(110.0)		(110.0)
Solvency ratio after dividend		**164%**		**162%**
Risk Appetite Solvency Ratio		150%		150%

Source: CA report on the Scheme

6.4 It can be seen from Figure 11 that the change in the capital position is trivial with only a small increase in the SCR (reflecting the non-profit guaranteed nature of the post conversion benefits) and a small decrease in the available Eligible Own Funds. This results in the Non-Profit Fund's SCR being comfortably covered and in excess of the risk appetite standard which SLOC currently applies to manage its long term business.

6.5 I conclude that the Scheme will have no material impact on the security of benefits of any of SLOC's policyholders.

7. APPROPRIATENESS OF THE ARRANGEMENTS FOR VOTING PURPOSES

7.1 For the purpose of the Scheme, the SLFC WPF with–profits policyholders will form a single class. For the Scheme to be approved more than 50% of the policyholders who vote must vote in favour and at least 75% by total value of policies.

7.2 The policyholders of the SLFC WPF have a common interest in the performance and experience of the SLFC WPF and consequently form a single class for the purpose of the Scheme. The operation and management of SLOC's business outside the SLFC WPF was described in Section 2 of the Scheme Report from which it is clear (see also section 8 below) that the economic interests of all other SLOC policyholders are not impacted by the operation of the SLFC WPF and, consequently, I do not consider it necessary for them to vote on the terms of the Scheme.

7.3 The voting measure takes into consideration the relative value of the policyholders who vote, so large policyholders have more influence. However, the additional requirement that a majority of individuals who vote, vote in favour, ensures that a small minority of large policyholders does not have undue influence.

7.4 In assessing the value of policies for the purpose of voting, the policy value will be calculated as the prospective policy value as at 30 June 2016 on the bonus setting basis.

7.5 This value will capture:

- The basic sum assured;
- Attaching reversionary bonuses;
- Special bonuses declared under the 1987 Scheme;
- Future reversionary bonuses at current rate; and,
- Terminal bonuses in-force.

7.6 It is desirable that the weight given to each policy can be simply determined from known policy parameters but that the value resulting for use of those parameters represents a fair relative weighting. However, it is preferable that the weighting reflects more fully all of the features of the policies, in particular, the allowance for future reversionary bonus and the discounting of future benefits (which partially offset each other). The prospective policy value on the bonus setting basis satisfies this requirement but it is a calculated amount which is not readily visible to policyholders. Since the values used will be those as at 30 June 2016, the value for voting purposes may be considered to be fixed and, although the real value of a policy may change after that date due to investment conditions, the relative values of policies will be broadly unchanged. Consequently, the proposed basis represents a reasonable and fair weighting for voting purposes.

7.7 The resulting weighting does not allow for settlement options which apply to most but not all of the contracts. The cost of settlement options is met by all SLFC WPF policyholders as a feature of the bonus setting policy, regardless of whether the policyholder benefits from the option or not.

7.8 It is noted that not all of the policies in the SLFC WPF have settlement options. However, the costs related to these options are effectively borne by all of the SLFC WPF with-profits policyholders by virtue of the bonus setting mechanism. Since the Scheme preserves the settlements option post-conversion, and the premium to be paid to the Non-Profit Fund will similarly be borne by all of the SLFC WPF with-profits policyholders, all policyholders have a common interest under the Scheme from a financial perspective. Consequently, I consider it reasonable to have a single voting class for all the SLFC WPF policyholders but note that the determination of the voting classes is ultimately a legal matter, upon which SLOC has taken appropriate advice.

7.9 I consider that the proposed approach to determine the weighting by value for voting purposes is appropriate.

8. IMPACT OF THE SCHEME ON SLOC'S OTHER POLICYHOLDERS

8.1 In this section, I consider whether the implementation of the Scheme will affect other policyholders of SLOC (and consequently whether they should be entitled to vote on the proceedings). In practice, this requires discussion of the change in the solvency position of the SLOC and whether then management of the SLOC WPF could be changed.

8.2 I have already discussed the impact of the Scheme on the security of benefits in Section 6 of the Scheme Report, where I concluded that the Scheme would have little effect on security.

Non-Profit Fund

8.3 The Scheme is not expected to impact on the operation of the Non-Profit Fund for existing policyholders, and in particular, charges, unit fund operation and SLOC's use of discretion are expected to be unchanged by the Scheme.

8.4 In my opinion, the Scheme will have no effect on the security and reasonable benefit expectation for existing policyholders in the Non-Profit Fund.

SLOC WPF

8.5 The assets, liabilities, capital requirements, operational arrangements and PPFMs for the SLOC WPF will not be changed by the Scheme.

8.6 The SLOC WPF can take support from the SLOC SSF which resides in the Non-Profit Fund. As discussed in Section 6, the Scheme is not expected to change materially the solvency or capital position of the Non–Profit Fund and, consequently, the availability of the SLOC SSF (which effectively lies in the Eligible Own Funds of the Non-Profit Fund) is unlikely to change as a result of this Scheme being implemented. Therefore, the support available to the SLOC WPF from the SLOC SSF is not expected to change as a result of this Scheme.

8.7 In my opinion, the Scheme is unlikely to alter the benefit expectations or security of benefits for policyholders in the SLOC WPF.

9. EQUITY OF THE SCHEME BETWEEN SLFC WPF POLICYHOLDERS AND SLOC'S SHAREHOLDERS

9.1 In this section, I consider the impact of the Scheme on SLOC's shareholders, primarily to ensure that the terms of the Scheme do not result in benefits accruing to shareholders which are materially more attractive than the benefits accruing to policyholders.

9.2 SLOC's shareholders have an interest in the terms of the Scheme:

- The value of the shareholders' share of future bonuses will be released to shareholders on completion of the Scheme;
- The shareholders will be required to fund additional capital to the Non-Profit Fund to support the capital requirements for the guarantees under the replacement non-profit policies (although the cost of this capital will be met through the terms of the Scheme);
- The shareholders will receive a premium in respect of settlement options, which will be based on realistic assumptions. Shareholders will subsequently meet the actual cost of fulfilling these options. The options are currently valuable and, since policyholders are informed of options on claiming, there is a risk that the take-up rates could increase materially – for example, the options could come to policyholders' attention by virtue of the Scheme; and,
- The shareholder will make some savings as a result of not incurring expenses related to the maintenance of the SLFC WPF.

9.3 Although it may be expected that some elements of the terms of the Scheme will be positive to shareholders, I do not consider that the terms of the Scheme will confer a material value enhancement for them, reflecting the risks which have been accepted. I also note that SLOC's shareholders have borne the considerable costs incurred in excess of the amounts to be charged to the SLFC WPF.

10. SUMMARY OF CONCLUSIONS

In my opinion,

- The proposed terms of the Scheme for the conversion of the with-profits benefits of the SLFC WPF policies to non-profit are fair and reasonable;
- The proposed formula for determining the value of each SLFC WPF policy will result in each policy having an appropriate relative weighting for the purposes of voting on the terms of the Scheme;
- The terms of the Scheme will have no material impact on the security of, or benefit expectations under, any other SLOC policies and, consequently, no other SLOC policyholders need to be party to the Scheme; and,
- The terms of the Scheme are unlikely to result in a relatively more favourable outcome arising for SLOC's shareholders than the SLFC WPF policyholders.

JL McKenzie 16 November 2016

Fellow of the Institute and Faculty of Actuaries

11. CERTIFICATE OF COMPLIANCE

11.1 I understand that my duty in preparing this report is to help the Court on all matters within my expertise and that this duty overrides any obligations I have to those instructing me and / or paying my fee. I confirm that I have complied with this duty.

11.2 I confirm that I am aware of, and have complied with, the requirements of Part 35, Practice Direction 35 and the Guidance for the Instruction of Experts in Civil Claims 2014.

11.3 I confirm that I have made clear which facts and matters referred to in this 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.

JL McKenzie 16 November 2016

Fellow of the Institute and Faculty of Actuaries

APPENDIX 1 - TERMS OF REFERENCE

General Requirements

1. It is the Expert's duty to help on the matters within his expertise. This duty is paramount and overrides any obligation to the person from whom he has received instructions or by whom he is paid.

2. Evidence presented to the Court should be, and should be seen to be, the independent product of the Expert uninfluenced by the exigencies of the instruction or Court proceedings.

3. The Expert should provide independent assistance to the Court where appropriate, by way of objective unbiased opinion in relation to matters within his expertise. He should never assume the role of an advocate.

4. The Expert should not omit to consider material facts within his knowledge which could detract from his concluded opinion.

5. The Expert should make it clear when a particular question or issue falls outside his expertise.

6. If the Expert's opinion is not properly researched because he considers that insufficient data is available, then this must be stated with an indication that the opinion is no more than a provisional one.

7. In a case where the Expert who has prepared a report could not assert that the report contained the truth, the whole truth and nothing but the truth without some qualification, that qualification should be stated in the report.

8. If the Expert changes his view on a material matter having read another expert's report or for any other reason, such change of view should be communicated in writing (through legal representatives) without delay, and when appropriate to the Court (and the Company).

Scope of the work of the Expert Witness in relation to the Scheme

The scope of the work to be undertaken is to consider the terms of the Scheme of Arrangement, covering:

A. The current position of the SLFC WPF (the Company's With-Profits fund which is to be restructured), its position within the Company and its need for some form of restructuring;
B. The terms of the Scheme;
C. The proposed voting arrangements and their fairness to affected policyholders;
D. The effects of the Scheme on the SLFC WPF policyholders; and
E. The effects of the Scheme on the other policyholders of the Company, both within its other with-profits fund and within the non-profit fund,

and to provide a comprehensive report on these matters to enable the Court to consider the proposed Scheme.

The review and report will address generally the way in which the Company has conducted its long term business in the SLFC WPF and the interaction of the SLFC WPF with the other with-profits funds and non-profit fund. It will deal inter alia with the following aspects:

- Memorandum, and the Articles of Association, at least insofar as these affect the rights, expectations and interests of policyholders;

- The terms of the policies issued by the Company;
- Promotional or marketing materials (including those documents issued under the Financial Services and Markets Act 2000 and previous compliance regimes) which would influence the reasonable expectations of policyholders;
- The existing and proposed internal working arrangements relating to the financial management of the long term business fund, including the operational and administrative arrangements which will apply to the policies to be altered under the terms of the Scheme;
- The terms and conditions expected to be imposed by the Scheme to be presented to the Court, including the views expressed by the governing body or management of the Company; and,
- The terms of the previous Schemes of transfer concerning the policyholders of the Company, as represented by the terms of the relevant PPFM.

The above list is not intended to be exclusive to any other aspects which may be identified during the completion of the project and which are considered to be relevant.

APPENDIX 2 – MANAGEMENT OF SLOC'S LONG TERM BUSINESS

Administration

1. SLOC has an executive and management team which provides central control and oversight but most policy administration is outsourced to third party providers. The third party arrangements are outlined in the following paragraphs. The effect of these arrangements is that unit costs for administration are fixed apart from increases due to inflation, as specified within the administration agreements. This approach to management means that many of the expenses incurred by SLOC are directly attributable to the business lines and will reduce in line with the run-off of the business since the funds are closed to new business. The central overhead cost is spread over all of the funds on an apportionment basis set by SLOC.

2. The administration of policies in the SLOC WPF is outsourced to Diligenta Limited ("Diligenta"), which is a third party unrelated to SLOC. The agreement with Diligenta ends in 2018, with provision for it to continue after that date subject to a 10% increase in the tariff of fees. Policy administration for the non-profit business in the Non-Profit Fund is also handled by a combination of Diligenta and Capita Life and Pensions Services Ltd ("Capita"), except for in-force annuities where Paymaster (1836) Limited (trading as Equiniti) is currently responsible for handling the benefit payments, tax and any related administration on the majority of annuity policies.

3. The policy administration of the SLFC WPF is outsourced and is largely undertaken by the third party administrator, Capita. A small amount of annuity business is administered by a third party reinsurance company under the terms of a reinsurance arrangement.

4. Investment management and administration are provided through agreements with a number of related and third party providers. These arrangements are subject to commercial contractual terms and protections.

5. The costs allocated to the SLOC WPF and the SLFC WPF are subject to terms arising from the previous transfers.

6. In line with the SLOC 1999 UK Scheme, administration and overhead costs (including the costs related to the SLOC staff pension fund) are allocated to the SLOC WPF based on the advice of its WPA in order to make a fair contribution to the relevant costs incurred by SLOC. Reflecting the diseconomies of scale which have occurred as the SLOC WPF has reduced in size, an agreement has been entered into in 2015 to curtail the costs allocated. This agreement will last for 5 years.

Products

7. The in-force business within the SLOC WPF consists entirely of with-profits endowment, whole life and deferred annuity policies.

8. The in-force business within the SLFC WPF consists mainly of with-profits endowment contracts and whole life policies (see 3.10).

9. The Non-Profit Fund contains a variety of protection and savings contracts including term assurance, income protection, deferred and in-payment annuities, and linked savings policies. The Non-Profit Fund also contains the business formerly allocated to the Cannon Fund and the CL WPF which converted to non-profit in 2014 and 2015 respectively.

10. Table 1 analyses the in-force business of the SLOC WPF and the Non-Profit Fund into broad product types.

Table 1: SLOC In-force business (excluding the SLFC WPF)

	31 December 2015			31 March 2016		
	Number of Policies	***Annual Office Premium (£'000s)***	***Best Estimate Liability* (£'000s)***	***Number of Policies***	***Annual Office Premium (£'000s)***	***Best Estimate Liability* (£'000s)***
SLOC WPF						
Life Conventional	41,153	11,959	575,187	39,882	11,388	570,941
Pensions Conventional	1,406	221	81,744	1,360	200	87,850
	42,559	**12,180**	**656,931**	**41,242**	**11,588**	**658,791**
Non-Profit Fund						
Life Conventional	15,539	2,536	107,225	14,965	2,406	94,597
Pensions Conventional	147,683	205	3,145,308	146,406	200	3,308,290
Life Linked	114,376	45,196	966,439	112,235	44,212	955,338
Pensions Linked	399,681	36,368	5,716,234	393,623	35,452	5,740,673
	677,279	**84,304**	**9,935,206**	**667,229**	**82,270**	**10,098,898**

***Gross of reinsurance**

Source: Sun Life of Canada

Approach to Financial Management and Policyholders' Reasonable Expectations

Overview

11. For the purpose of the Scheme Report, it will not be necessary to consider in detail the approach to financial management for each fund maintained by SLOC. As discussed in this report, other than the changes to SLFC WPF (and the consequent allocation of the impacted policies to the Non-Profit Fund), no changes are proposed to the financial management of any other sub-funds of SLOC. However, to the extent that all of the funds are part of SLOC, changes in the dynamics of one part of SLOC could affect another. The following paragraphs provide an overview of relevant aspects of financial management.

12. Before describing financial management, it is important to understand the key features of the products in force which are relevant in this report. These are described in the following sections.

13. The conventional with-profits contracts are principally traditional endowment or whole life assurances or pensions deferred annuity contracts which have significant long term investment guarantees but do not have significant options.

14. For with-profits business, the level of benefit payments is influenced primarily by the investment and mortality experience of the relevant with-profits fund and the operation of discretion by SLOC when distributing profits to policies. Generally speaking, with-profits business is subject to a number of discretionary powers which may be applied by the company (e.g., setting the investment mix, allocating expenses to policies, increasing guarantees by allocating bonuses and setting final payouts). The level of capital available may play a significant role in this process.

15. The majority of the non-profit non-linked contracts are on guaranteed terms which do not depend on the application of discretion by SLOC. For a certain number of the vested annuity contracts and income protection contracts in force, the future payments are inflation linked. Although this means that the precise amount of the future payments cannot be determined with certainty, the basis by which the payments are determined is guaranteed.

16. For linked contracts, the value of the benefits payable is established by reference to the value of units invested in the internal linked funds maintained by SLOC, although some product types may have guarantees of capital payable on specified dates or guaranteed rates of return, which override the value of units allocated. There may be discretionary powers available to the company in setting unit prices (e.g., in determining when unit pricing should switch from an expanding fund to a contracting fund basis, or how and when to allow for tax) but these considerations generally reflect fairness between policyholders rather than between policyholders and shareholders. Some policy types have reviewable charges in respect of the risks insured or in respect of the allocated costs of administering the contract.

Regulatory controls

17. Under the current regulatory regime, the principle of treating customers fairly ("TCF") should be applied. This requires actions to be considered by reference not only to the way such actions may have applied in the past but also to whether they are fair in an absolute sense. The principle of TCF goes much further than simply recognising policyholders' reasonable expectations ("PRE"). The key features which I believe should be considered in addressing TCF and PRE are:

    i. Security of benefits: this is the expectation that benefits will be paid as they fall due; and,

    ii. Fair treatment: this must be assessed in the context of the effects which actions may have on different classes or generations of policyholders or on shareholders and should have regard to contractual terms and the way in which the contracts have been promoted and managed in the past.

18. To some extent, the assessment of PRE will have been formulated by the communications given to the customers both at the point of sale and subsequently, or by other statements of practice. However, recognising that discretionary powers should be applied appropriately, rules or codes of practice have been established which require discretionary powers to be applied in a relevant, proportionate and considered fashion. Publicity and transparency are important in demonstrating that the principle of TCF is adhered to.

With-profits business

19. A detailed description of the financial management of with-profits business is now set out in the statement of "Principles and Practices of Financial Management" ("PPFM") which with-profits companies must maintain and make available to policyholders. I have taken the full PPFM as the starting point in my assessment of the management of with-profits business.

20. In the PPFM, "Principles" are overarching statements of the intended terms for the management of with-profits business and these are unlikely to change very frequently. If changes (other than minor editorial changes to improve clarity) are required, affected policyholders must be notified at least 3 months before the changes take effect. The statement of the "Practices" reflects the application of the Principles currently adopted by the company. Practices may be expected to change more frequently than Principles, reflecting changing circumstances. Changes to the Practices must be consistent with the Principles, but do not require pre-notification to policyholders.

21. In the SLOC WPF, with-profits benefits are determined by reference to the asset share. The asset share of a policy is an accumulation of the premiums paid, allowing for the investment returns earned, after tax if appropriate, but after deducting the costs of administering the contract, commission payments to agents, and charges for insurance risks and guarantees, if appropriate. The asset share therefore represents broadly the accumulated value in respect of each policy based on the fund's performance and experience during the policy's period in force. Asset shares can be calculated for actual policies or may be calculated by reference to modelled or specimen policies and a model created to represent the whole of the in-force business.

22. The asset share does not provide the policyholder with any additional rights either to the assets underlying the asset share or, indeed, to any value equivalent to the asset share value, as the company retains full discretion up to the point of claim to pay a value different from the asset share (e.g., by smoothing). In practice, subject to smoothing, the asset share serves as a reference point from which fair payouts could be measured.

The existence or use of asset shares is unlikely to have been a matter with which most policyholders were familiar before the introduction of PPFM, but a reasonably informed observer would have recognised that asset shares were a major determinant of PRE and a basis for assessing TCF.

23. Clearly the value of the asset share is highly dependent upon investment returns and therefore upon the asset allocation to investment classes. The asset allocation is influenced by the capital available to the with-profits fund (whether held within the fund or by means of a commitment or requirement to rely on capital outside the fund). With-profits benefits are also influenced by the level of costs allocated to the with-profits fund whether these are then allocated directly to asset shares or borne by the fund itself.

24. In the SLFC WPF, with-profits benefits are determined by the Fund's Prospective Value. The Prospective Value equals the present value of the expected future benefits, expenses and shareholder interest in future profits less expected future premiums. The present value reflects the time value of money, and requires an assumption on the future investment return on the Fund's assets. A policy's Prospective Value is also known as a Bonus Reserve Valuation ("BRV").

25. The PPFM will reflect the terms of any prior schemes, as well as the requirements of the Conduct of Business Sourcebook in the FCA Handbook. In particular, the PPFM will take into account COBS 20 which covers with-profits business. It should be noted that the terms of High Court Schemes approved prior to the introduction of the COBS Rules usually take precedence over those rules.

26. SLOC publishes PPFM for the SLOC WPF and separately for the SLFC WPF. The PPFM are described at 2.21, for the SLOC WPF, and the PPFM for the SLFC WPF is considered in Section 3. The CL Fund is not considered in this report since it ceased to exist in March 2015.

Unit-linked business and reviewable charges business

27. As noted above, discretionary powers are more limited in respect of unit-linked business. There are industry codes of practice and regulatory requirements which limit the scope of these powers and it is common for companies to maintain documents similar to (but much more limited in scope than) the PPFM describing how unit-linked business is managed. The scope is much narrower since financial management of unit-linked business does not rely materially on the amount of available capital. However, a change to the expense base of a company or a change to the balance of expenses allocated to business lines would affect benefits for unit-linked business if the change can be passed on to policyholders by way of increased charges.

28. SLOC documents its procedures for the financial management of its unit-linked business and its reviewable charges business.

SLOC WPF PPFM

29. SLOC publishes PPFM for the SLOC WPF. The full PPFM describes in more detail the approach adopted in managing the SLOC WPF. The PPFM also reflects the terms of the SLOC 1999 UK Scheme.

30. The SLOC WPF has a set of overarching Principles which have the aim of:

- meeting all legal and regulatory requirements (including ensuring the fund remains solvent on a stand-alone basis), meeting the SLOC 1999 UK Scheme requirements and observing all policy contract terms;
- distributing the entire fund at a pace that ensures each policyholder receives a fair share of the whole fund;
- meeting all policyholders' reasonable expectations regarding payouts, including paying all guaranteed benefits as they fall due; and,
- managing the fund in a sound and prudent manner and treating all policyholders fairly having regard to their contribution.

31. Although all of these principles are important in terms of the management of the SLOC WPF, in the context of the Scheme Report and consideration of the Scheme, the first of these will require closest attention to ensure its continued application.

32. The key elements of the Principles are:

- Benefit payments to life policyholders with endowment plans are set having regard to underlying asset share values and the level of any contractual guarantees, so as to ensure equitable treatment between different cohorts of policyholder and product lines. For whole life contracts, a prospective valuation method may be used to achieve this.
- Pensions policyholders receive a fair apportionment of the fund based on the investment return earned on the assets purchased with the premiums paid, allowing for the amounts charged for the expenses of administering the plan and any guaranteed minimum benefits that exist.
- Reversionary bonuses are set to moderate the growth of guaranteed benefits and maintain the potential for terminal bonus payments at the end of the contract. Once added, the reversionary bonuses cannot be removed and are added to the guarantees under the policy.
- Terminal bonuses on endowment plans are set so as to bring benefit payments into line with asset shares, subject to maintaining the financial strength of the fund and the application of smoothing, which is expected to be cost neutral over time. Terminal bonuses for whole life policies are set such that the prospective value of future benefits is equal to the corresponding share of the fund's assets.
- The investment strategy is set to achieve satisfactory benefits to with-profits policyholders, having regard for the financial strength of the SLOC WPF on a stand-alone basis without recourse to any other assets of SLOC.
- However, the SLOC WPF may rely on the SLOC SSF to support guaranteed benefit payments in extreme adverse economic circumstances in line with the requirements of the SLOC 1999 UK Scheme.
- No surplus may be distributed to shareholders from the SLOC WPF.
- The SLOC WPF need not be maintained as a separate fund when the value of the assets in the fund falls below £100 million[6] and subject to regulatory approval and agreement of the WPA may be amalgamated with the Non-Profit Fund. If the fund is wound up, any surplus will be distributed in the form of a guaranteed bonus or an increase in benefits to the remaining plans and the plans will become non-participating from that point on. The SLOC WPF must be wound up if the value of the assets in the fund falls below £10 million[7].

33. The PPFM also contains a summary of the main components of the company's asset share calculation. Neither the cost of guarantees nor the cost of smoothing are included within this calculation because the SLOC WPF Inherited Estate includes a provision for these items.

Excess Surplus and Run-off Plans

34. A company transacting with-profits business is required to consider whether the capital available in each with-profits fund is in excess of the capital required to support the business plans and risk appetite of that fund. Where more than one with-profits fund is maintained, the test should be applied separately to each fund. If excess capital is identified, then a plan must be formulated to remove the excess through either distribution or reattribution of the capital.

35. All of the with-profits funds maintained by SLOC have been effectively closed to new business for some years and therefore the distribution of assets in excess of the asset shares is already a feature of the management of these funds (and explicitly referred to in the Principles in the PPFM). The approach adopted demonstrates that, in each fund, a balance has to be struck between distributing the excess assets equitably and maintaining a satisfactory long term solvency position for each fund.

[6] Adjusted for movements in the Retail Price Index since March 2000.

[7] Adjusted for movements in the Retail Price Index since March 2000.

APPENDIX 3 - DOCUMENTS REVIEWED

The principal documents reviewed in preparing this report were:

Public

- Annual Regulatory Returns to the PRA as at 31 December 2014 and as at 31 December 2015; and
- Principles and Practices of Financial Management ("PPFM") for each of the with-profits funds.

Private (or currently unpublished)

- The Scheme;
- The Explanatory Statement and Questions and Answers Leaflet to be sent to policyholders;
- The reports on the terms of the Scheme prepared for SLOC's Board by the CA and WPA;
- The initial Solvency II submission to the PRA as at 31 December 2015;
- The quarterly Solvency II submission made to the PRA as at 31 March 2016;
- Bonus recommendation reports for the SLOC WPF and the SLFC WPF in respect of 2016 (dated 18 January 2016);
- Bonus recommendation reports for the SLFC WPF in respect of the years 2012 to 2015;
- WPA Report on the exercise of discretion during 2015 (dated 2 March 2016);
- The SLFC WPF Run-off Plan as at November 2014;
- WPA Report on the terms of the proposed transfer of the non-profit business of the SLFC WPF to the Non-Profit Fund (dated 19 May 2015);
- WPA Report on the need for an expense agreement for the SLOC WPF (dated 15 September 2014);
- WPA Report on the treatment of overhead expenses charged to the SLFC WPF (dated 26 May 2015);
- External auditors opinion on the appropriateness of the Day 1 Solvency II figures (dated 26 April 2016);
- Report on the apportionment of maintenance expenses for the SLOC WPF and the SLFC WPF in 2016; and,
- Individual Capital Assessment ("ICA") Reports as at 31 December 2013 (dated 18 June 2014) and 2014 (dated 1 June 2015) prepared by SLOC's Chief Actuary.