ELAS

Proposed Scheme to transfer German and Irish policies to ELI

SUMMARY OF THE REPORT OF THE INDEPENDENT EXPERT

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Introduction

The purpose of this document is to provide policyholders with a summary of my report on the proposed transfer of German and Irish policies from Equitable Life Assurance Society to Equitable Life Ireland DAC.

THE INDEPENDENT EXPERT

When an insurance company decides to transfer some or all of its long-term insurance business to another insurance company ("Part VII transfer or scheme"), the law in the UK requires approval by the High Court. An Independent Expert is required to report to the High Court on the contents and implications of any Part VII transfer or scheme. I am the Independent Expert appointed to provide this report to the High Court. I qualified as a Fellow of the Institute of Actuaries in 1988 and hold Chief Actuary and With-Profits Actuary practising certificates issued by the Institute and Faculty of Actuaries. I have over 40 years' experience in the UK life assurance industry. I can confirm that neither I, SDA's partners nor any of SDA's employees hold any insurance policies or have any other financial interest in ELAS (or any of their subsidiaries).

There are rules and guidance about what should be included within the Independent Expert report, laid down by the UK regulators, the Prudential Regulatory Authority ("PRA") and the Financial Conduct Authority ("FCA") which reside in the PRA's Statement of Policy on "The Prudential Regulation Authority's approach to insurance business transfers" from April 2015 and the chapter marked SUP18 in the FCA Rulebook. The report has to give my views on the effect that the Transfer has on various classes of policyholders. This includes the policyholders whose policies are being transferred (the "Transferring Policyholders") and policyholders whose contracts are not transferring (the "Remaining Policyholders"). I need to consider different sub-groups within these groups of policyholders depending on whether I believe the impact will be markedly different between the groups.

I am required to give an opinion on whether any of these groups of policyholders are "adversely affected" and whether any adverse effect is material. I look at the security of the benefits promised by Equitable Life Assurance Society ("ELAS") to its policyholders, policyholders' benefit expectations especially if they have some element of discretion attached, the approach to unit pricing and investment fund mandates for unit-linked policies (policies where the some or all of the benefits are directly linked to a pool of specific assets of the insurer) and whether policyholders can expect the same level of service from the insurer in the future. Discretionary aspects of policies are particularly relevant on "with-profits" policies where the policies' benefits depend upon the profits of ELAS and there is discretion exercised by the Board on how to share these profits and the timing involved. However, it is also present in other policies such as unit-linked policies on unit pricing and any policy with reviewable premium rates.

This document is a summary of the Independent Expert report ("the Report") and is subject to the same limitations on its use as those set out in the Report. This summary of the Report should be considered in conjunction with the full Report and reliance should not be placed solely on this summary. In the event of conflict between this summary and the full Report, the full Report prevails. Copies of the full Report can be obtained at www.equitable.co.uk or by writing to ELAS at the address provided in the communication pack.

ELAS

ELAS was established in 1762 and was registered in 1892 as an unlimited company with its current name. ELAS is regulated by the PRA and FCA in the UK. Its business consists of protection products (including life cover and critical illness) and retirement income planning products (including annuities) for groups and individuals as well as savings products. ELAS closed to new business in December 2000.

The majority of ELAS's business was written in the UK. However, a small proportion was written in Guernsey, Germany and Ireland. The German business comprises of products designed specifically for the German market as well as UK–style policies. The policy value for the German Business at 31 December 2017 was £16 million, with approximately 800 benefits. The policy value for the Irish business at 31 December 2017 was £42 million, with approximately 4,000 benefit. Policies may have more than one benefit.

EQUITABLE LIFE IRELAND DAC

Equitable Life Ireland DAC ("ELI") is a subsidiary in Ireland which will be set up by ELAS. ELI will be a Designated Activity Company, which will be 100% owned by ELAS. German and Irish policies will transfer to ELI from ELAS via a Part VII Transfer. The UK-style German and the Irish with-profits business will be allocated to ELI's with-profits Fund and reinsured back to the UK. The remainder of the German and Irish business of ELAS will be allocated to the ELI Main Fund.

SOLVENCY II

Solvency II is the European Economic Area regulatory framework that insurers and reinsurers in the UK are currently subject to. Under Solvency II, an insurer's liabilities are referred to as "technical provisions" and the capital it is required to hold in addition to the assets to cover the technical provisions is the Solvency Capital Requirement ("SCR"). The SCR is the amount that ensures that, over a period of one year, 99.5 out of 100 times, an insurer will have sufficient assets to cover its technical provisions. Solvency II lays down detailed rules and principles that need to be followed in calculating the technical provisions. Solvency II also requires insurers to have robust governance and risk management arrangements in place.

The scheme

WHY IS THE SCHEME BEING PROPOSED?

As stated above, ELAS has policies written historically through its Irish and German branches to policyholders based in Ireland and Germany respectively. After the UK withdraws from the European Union ("EU"), and assuming no deal is reached on how to manage these types of policies between the UK and the EU (a "hard Brexit"), ELAS would not be able to administer or pay benefits to these policyholders. Therefore, ELAS is setting up a subsidiary in Ireland (which will continue to be a part of the EU), ELI, and transferring these policies to this subsidiary. The policies can then continue in force irrespective of the UK's withdrawal from the EU.

The only policies being transferred are those where the policies had been originally sold by the Irish or German branches and this Report refers to these as Transferring Policies. Other policies will remain with ELAS. This Report refers to these as Remaining Policies.

ELI will be based in Ireland and will be regulated by the Central Bank of Ireland ("CBI"). The number of benefits and the policy values transferred are expected to be in the order of 5,000 and £58 million, although guarantees and other liabilities will increase the total liabilities transferred to £78 million and assets to £85.5 million.

ELI has not been granted permissions from the CBI to service the Transferring Policies but the CBI expect to do so in January. I will issue a supplementary report which will comment on the status of the granting of permissions for ELI.

The Transferring Policies will include:

- Irish with-profits business;
- German and Irish unit-linked business;
- German and Irish conventional non-profit temporary assurances, deferred annuities and annuities in payment;
- UK-style German with-profits business;
- German-style with-profits business; and
- Guaranteed Annuity Rates ("GAR") Liabilities.

The Scheme is a "Part VII Transfer" as defined under the Financial Services and Markets Act 2000. It requires approval by the High Court and allows anyone affected by the Scheme to have their views raised.

Irish with-profits business and UK-style German with-profits business will be transferred to a new Ring-Fenced ELI with-profits fund. They will no longer share in the profits of the main ELAS fund nor will they directly share in the profits generated by the other Transferring Policies. The other Transferring Policies will be in ELI but outside the Ring-Fenced ELI with-profits fund.

Normally a new insurer will require its own administration system and its own administrators. To ensure continuity of service, ELAS is putting in place a Management Services Agreement ("MSA") whereby all of the administration of the policies within ELI will be carried out by ELAS for set fees. There will be additional expenses for running ELI in terms of new senior management and some additional costs for maintaining a separate legal entity. These have been estimated at £0.4 million to £0.5 million a year. Technical provisions will be established to meet these continuing costs within ELI's balance sheet.

To ensure that the Transferring with-profits policyholders continue to share in the profits (and losses) of the main ELAS fund, a new Reinsurance Agreement has been established which will cover all the benefits and premiums of the with-profits Transferring Policies and allow for any profits from the main ELAS fund as well as investment returns and expense profits to be shared with the Transferring Policies in the same way as would have been done prior to the Scheme. I have reviewed the Reinsurance Agreement and I believe it is reasonable and it would achieve its aim.

ELAS will transfer sufficient resources to capitalise ELI so that 150% of the SCR as required under Solvency II, the current solvency regime for EU insurers will be covered at outset as well as providing for the technical provisions covering any liabilities transferred. A Capital Support Mechanism has also been established which will ensure that ELI can call on ELAS for further capital injections if the coverage of the SCR falls below 120%, as long as this would not endanger the solvency or liquidity of ELAS. Dividends will be paid by ELI to ELAS as long as ELI is achieving 150% coverage after the dividend payment.

ALTERNATIVES

There were two main alternatives to carrying out the Scheme. The first was to approach the CBI and BaFin (the German regulator) to ask whether ELAS could continue to administer the policies after the UK leaves the EU without establishing an EU-based insurer.

ELAS approached the Central Bank of Ireland ("CBI") and was informed that the CBI did not have the power to allow this to happen. It would have to follow the single market EU regulations and would not allow ELAS to continue to administer these policies from the UK unless the terms of the EU's withdrawal from the EU specifically allowed for access to the single market for UK life insurers. As the Irish policyholders make up the bulk of the Transferring Policyholders, this route was not pursued. We note that BaFin has recently published a draft regulation change that would enable policies such as those for ELAS to continue to be serviced from the UK during any transition period. However, this would not be a permanent solution dependent on a transitional period being agreed within the Brexit negotiations (and would only affect German Policies), so does not give a viable long-term alternative.

The other alternative was not to carry out the Transfer and to hope that the terms of the UK's withdrawal from the EU would allow for the policies to continue to be administered in the UK. This was rejected as an option unless there were adequate transitional provisions, due to the risk of policyholders not being able to receive their benefits. However, ELAS have confirmed that if there are adequate transitional provisions, then the Transfer will not go ahead.

Complications from other ELAS planned events

In June 2018, ELAS entered into an agreement to transfer the Society and its policies into Reliance Life, part of Life Company Consolidation Group ("LCCG").

There are two schemes that ELAS expects to enter into.

The first is a Scheme of Arrangement which will convert all of the ELAS with-profit policies into unit-linked policies. This will be achieved by uplifting all of the asset shares (the underlying realistic value of the policy used as a guide to set bonuses and future payouts) by distributing all of the with-profits assets. Secondly, these asset shares will then be switched into unit-linked policies. The guaranteed investment returns and guaranteed minimum benefits will then cease to apply. The uplift will allow for the value of the guarantee given up. The Scheme of Arrangement will take place at the same time as the sale of ELAS (and ELI) to Reliance Life.

The second is a transfer whereby all policies in ELAS will then be transferred into Reliance Life ("Reliance Transfer"). The empty shell of ELAS will then be wound up.

These schemes are expected to take place by the end of 2019, several months after the planned Effective Date of the Scheme to transfer the Irish and German business considered in this report.

The policies transferred to ELI are not expected to directly take part in the Scheme of Arrangement or the Reliance Transfer. However, the ownership of ELI is expected to transfer to Reliance Life when the Scheme of Arrangement is implemented. If there is adequate transitional provision, the Transfer will not go ahead and the Irish with-profits policies will be expected to take part in the Scheme of Arrangement and all policies will be expected to take part in the Reliance Transfer.

My approach

I am not required to consider the impact of the later two schemes (the Scheme of Arrangement or the Reliance Transfer) on policyholders. That is the work of other Independent Expert(s) who will report in due course.

However, I need to consider as part of my report on the Scheme of Transfer to ELI the potential effect of three future scenarios that could arise after the Transfer has been completed:

1. The Scheme of Arrangement and Reliance Transfer do not take place;
2. The Scheme of Arrangement and Reliance Transfer do take place; and
3. The Scheme of Arrangement takes place (including the sale of ELAS (and ELI) to Reliance) and the Reliance Transfer does not take place.

ELAS management believes that it is extremely unlikely that only one of the Scheme of Arrangement or Reliance Transfer can occur whilst the other does not. From correspondence I have received from ELAS management, I believe that the Reliance Transfer cannot occur without the Scheme of Arrangement but the Scheme of Arrangement could (in an unlikely scenario) occur without the Reliance Transfer. Note that the Scheme of Arrangement cannot take place without the sale of ELAS (and ELI) to Reliance.

If the Reliance Transfer goes ahead, then the Reinsurance Agreement, the MSA and the Capital Support Mechanism will fall away. There is the intention of creating new forms of these agreements with Reliance Life/LCCG but there is no guarantee of this occurring and no expected resulting agreements.

The full Report is, therefore, more complex than other similar reports as there is an additional degree of uncertainty on the end destination.

Findings

Financial impact

I have examined documents from ELAS on the impact on ELAS's balance sheet and on the expected development of ELI.

ELI will be owned 100% by ELAS and will be consolidated into ELAS's balance sheet. Overall, the impact on the consolidated firm will be a reduction in the free assets (or "Own Funds") by the expenses of carrying out the Transfer, establishing ELI and paying the increased ongoing expenses of ELI into the future. The Reinsurance Agreement and the MSA reduce the costs of managing ELI to extra senior management, accounting, compliance and actuarial costs. The administration of the policies and their benefits will still be carried out by ELAS. The costs amount to £2.5 million on the Transfer and establishing ELI, and £0.4 million to £0.5 million annual costs thereafter. The latter cost is capitalised in the balance sheet immediately at an extra expense reserve of £9 million (approximately 11 million Euros). Note that the cost will be shared amongst all the Transferring and Remaining with-profits Policyholders, which is in line with the pooling concept for with-profits business and statements to policyholders made by ELAS about how it runs its with-profits business.

Therefore, there is a loss to policyholders from the exercise of £11 million to £12 million. ELAS has total assets of £6,613 million as at 31 December 2017 and total Technical Provisions of £5,850 million, so the cost is a small proportion of total assets. Coverage of the Solvency Capital Requirement before and after the proposed Transfer, assuming the Transfer occurred on 31 December 2017, remains at 167%.

ELI has two five-year projections in its Own Risk and Solvency Assessment provided for the CBI based on 31 December 2016 figures to agree establishment of the company. The main "best estimate" projection shows a growing level of solvency. There appears to be an orderly run-off from this initial five-year projection. The amount of assets as at 31 December 2017 is estimated at £85.5 million with Technical Provisions at £78.0 million leading to own funds of £7.5 million with a Solvency Capital Requirement of £5.0 million. The 150% coverage of SCR at outset is slightly lower than the 167% for ELAS and, in my opinion, is adequate as it is well in excess of regulatory requirements.

For all Transferring policies, there will be a loss of protection from the Financial Services Compensation Scheme which provides compensation if a UK life assurer cannot meet its obligations. As stated above, I believe that ELI will have sufficient capital available and that its Own Risk and Solvency Assessment shows a reasonable level of ongoing solvency. Therefore, I believe that the loss of the FSCS protection will not cause a loss to policyholders.

The Capital Support Mechanism gives ELI comfort that ELAS will support ELI's solvency to at least 120% coverage of its SCR as long as the support would not cause ELAS to have solvency issues. Dividends will only be paid by ELI to ELAS if ELI is achieving 150% coverage after the dividend payment.

Therefore, the impact of the Transfer is marginally negative due to the extra costs involved.

As these costs are a requirement of a "hard Brexit" which is out of the control of ELAS, and the costs have been minimised by the three agreements put in place by ELAS, I believe that this does not materially adversely affect policyholders.

Benefit impact including areas where benefit security could be weaker

For ELAS policyholders, there is no material impact from the Transfer other than the slight impact of the additional costs mentioned above on policyholders' benefit expectations and the security of these benefits.

For ELI unit-linked and non-profit policyholders, including German-style German with-profits policies and Guaranteed Annuity Rate liabilities, no impact will occur. The MSA and the continuation of investment management agreements ensures that the position does not change.

I have also examined the governance arrangements that will be in place in ELI and believe that there will be adequate controls locally within ELI to meet reasonable policyholder expectations.

ELI's with-profits policyholders (except the German-style with-profits policyholders) will be placed in a Ring-Fenced Fund and will no longer benefit from the profits (and losses) of the non-profit and unit-linked business nor from the wider fund of ELAS. The Reinsurance Agreement is designed to offset this potential loss by ensuring that all of the profits of the total ELAS fund including those derived from the non-profit and unit-linked business from ELI is shared back to ELI as if they were still part of the main fund including maintaining the investment returns that would be available if they had not left the main fund. Again, the MSA is designed to ensure the same service is maintained. The Capital Support Mechanism has been established to provide further capital security for ELI.

Therefore, assuming that the three agreements are in place, there is no material adverse effect on Transferring Policies. The next section discusses these agreements and explains what happens when they fall away.

When the Scheme of Arrangement takes place, ELI's with-profits policies (except the German-style with-profits policies) are expected to have an increase in their asset shares so as to distribute all the ELI with-profits assets in the same way that the Scheme of Arrangement aims to distribute all the with-profits assets of ELAS. Asset shares are a calculation of the share of the fund that is deemed to belong to each policy by accumulating their premiums less expenses less an allowance for the cost of risk benefits at the actual investment return. They are commonly used in with-profits companies to give some indication of the fairness of any payout. The increase is equivalent to the base uplift under the Scheme of Arrangement and is likely to be in the order of a 60% or 70% increase (to 160% or 170% of the previous asset shares). The policies will then pay the greater of uplifted asset share or guaranteed values. The guarantees including the guaranteed minimum benefits will remain at their previous value. These guarantees will be less valuable against the asset share after the uplift and it is expected that the only policies that will still normally benefit from the guarantees will be those with the 3.5% guaranteed investment return. The value of the guarantees (including the guaranteed minimum benefits) is expected to shrink to £0.5 million for ELI. There is no guarantee, at present, that the uplift in asset shares will take place as part of the Scheme of Arrangement. However the intention to apply the uplift will be covered by the Witness Statements given to the

Court in relation to the Scheme, so it is unlikely that the uplifts will not be carried out, provided the Scheme of Arrangement occurs.

However, the Irish with-profits policies will not be automatically switched into unit-linked policies as would have occurred under the Scheme of Arrangement. They will continue as with-profits policies and may be allowed to switch into unit-linked with their uplifted asset shares if they wish (some policy types will not be able to switch). German Policies are not able to switch at present, as such a switch would give rise to a policyholder tax charge in Germany and this will continue. For ELAS policies, a further uplift is made over the level proposed for ELI to remove the guarantees automatically. The equivalent further uplift for affected with-profits Transferring Policies would have been in the order of a further 3.9% of their asset share. However, at present, it is proposed that this further uplift will not take place for ELI policies.

The increase of benefits for the affected Irish with-profits policyholders will, therefore, be less for ELI than if they had remained in ELAS. However, they still retain their guarantees and, in my opinion, the amount of benefit lost will be small compared with the large increase and will only affect a sub-group of policyholders where the guarantee retains material benefit. I suggest that this is re-examined by ELI's Board when it considers fair values for allowing policyholders to switch from with-profits to unit-linked for the policies affected. ELAS, at present, is proposing no such uplift.

The Agreements – status and what happens when they fall away

The Reinsurance Agreement, the Capital Support Mechanism and the Management Services Agreement can be seen as three agreements that, together, ensure that no material adverse effect is suffered on the Transfer and that ELAS has no reduction in its scale due to the Transfer (a small effect could otherwise be possible due to spreading expenses over fewer policies).

They have all been reviewed and approved by the Executive Committee of ELAS, reviewed and approved for submission to the Court by a Board Sub-Committee at its meeting on 20 November 2018 and the final versions are expected to be reviewed and approved by the ELAS Board in February.

Although, these agreements could change over time, I would not expect them to change in the normal course. However, the Reliance Transfer is likely to lead to the agreements falling away. Although the MSA would transfer to Reliance Life, the Reliance Transfer would allow Reliance Life to give three months' notice to terminate it. The Reinsurance Agreement and Capital Support Mechanism would not automatically transfer unless this explicitly formed part of the scheme for the Reliance Transfer. Note that new similar agreements with Reliance Life/LCCG are expected but not guaranteed.

If the MSA is terminated and is not replaced by a similar agreement with LCCG, ELI will need to source an administration system and extra staff. I estimate that these actions are possible and would not cause ELI to become insolvent, although there would be additional cost and expenditure of senior management time. In my experience, it is perfectly possible to run a with-profits insurer of ELI's scale with independent resources using outsourcing of functions such as investment management, internal audit, actuarial, IT support and compliance support where the scale would not make full internal functions possible. ELI could also negotiate with ELAS / Reliance for release of copies of the administration system, although a replacement system can normally be purchased and put in place for £1 million approximately (in my experience). The termination of the MSA would therefore, as a minimum, be likely to lead to additional costs of putting in place new arrangements, but I do not anticipate this would be material and indeed replacing the MSA could lead to savings if ELI was able to negotiate lower costs elsewhere.

If the Reinsurance Agreement is terminated, assets will be transferred to ELI equivalent to the liabilities reinsured. There is, therefore, no material impact on the security of ELI other than a possible change in its Solvency Capital Requirement from counterparty risk (to ELAS) to market risk (for the assets). As the assets are proposed to be government bonds, market risk will be minimal. There is, a potential loss in the lack of sharing of the profits achieved in the remainder of the ELAS portfolio including its ownership of the non-profits and unit-linked portions of ELI, but this would have been the case anyway if the Transfer had not occurred but the Scheme of Arrangement had occurred. The uplift in asset share will reflect the value of the non-profit and unit-linked business to the estate of ELAS. Therefore this is not expected to reduce policyholders' expected benefits.

If the Capital Support Mechanism is terminated and no mechanism is put in its place, there will be a small not material loss in security for ELI policyholders. However, ELI will instead be covered by the group capital support policy of LCCG, which I understand aims for solvency coverage of 135% to 150% for all of its insurance entities. I believe the solvency coverage would be reasonable.

Overall, although the termination of these agreements could create a small adverse effect on the Transferring Policies, I do not believe that there would be any change in my conclusion overall as a result of all three agreements ceasing.

Conclusions

My conclusion is that there will be small losses for all with-profits policyholders in terms of their benefit expectations and security due to the Scheme going ahead. However, the impact of a “hard Brexit” or a withdrawal from the EU, which does not allow UK insurers to continue to service and administer EU-based business, is far greater on these policyholders where they could, potentially, lose all their benefits, due to ELAS being unable to service their policies.

Overall, I do not believe any policyholder is materially adversely affected by the Scheme.

11th December 2018