

RELIANCE MUTUAL INSURANCE SOCIETY LIMITED

14 February 2008

Memorandum to : BOARD OF DIRECTORS

From : MR T J BIRSE MR R J HOULSTON
 Actuary With Profits Actuary

Subject : **Transfer of Family Assurance Friendly Society tax-exempt
business to Reliance Mutual**

1. Introduction

When the former Time Assurance friendly society business was transferred from Family Assurance to Reliance Mutual in 2004, tax legislation at the time did not permit friendly society tax-exempt business to be transferred to an insurance company while retaining tax-exemption. Consequently this business, which comprised a separate ring fenced sub fund within Family Assurance was not transferred. Reliance Administration services took over the administration of the business under a third party administration (TPA) agreement. Investment management remained with Family Assurance.

There was no adjustment to the price paid for the Family Assurance business once it became clear that the tax-exempt business could not be transferred. It was realised that under the TPA structure, both parties would be involved in work that would not have been necessary had the business been able to be transferred. Reliance Mutual and Family Assurance had an unwritten agreement that, should the tax legislation permit, they would enter into an agreement to transfer the business by means of a scheme under Section 86 of the Friendly Societies Act. As both sides would benefit, there would be no payment at the time of any second transfer.

The Finance Act 2007 made the necessary amendments to tax legislation, and a scheme of transfer has been prepared. A timetable is in place with the aim of achieving a legal transfer of the business on 31 July 2008. This paper sets out the case for the acceptance of business from Family Assurance Friendly Society (FAFS).

In our roles as the Actuarial Function Holder and With Profits Actuary of RMIS, we comment on the implications of the scheme to the members of Reliance Mutual, although we make some passing comments on the effect of the scheme on transferring policyholders. The Actuary of FAFS is similarly reporting to the board of that society on the implications of the scheme for the transferring policyholders.

2. Executive Summary

- 2.1 The scheme changes the form of the benefits of transferring with profits policies so that they become unit linked contracts on the transfer date. This means that it is not necessary to establish a further ring fenced with profits sub fund, and that all the business can be transferred into RM WPSF. The capital resource requirements of the transferring business will have to be found from within RM WPSF.
- 2.2 We do not believe that the security of existing members of the Society will be adversely affected to any material extent.
- 2.3 Benefit expectations of the Society's with profits policies are unlikely to be materially altered. As the business is already being administered within the Reliance Group, there will only be minor expense savings.
- 2.4 Benefit expectations of the transferring FAFS policyholders are not adversely affected by the scheme.
- 2.5 Transferring policyholders will become members of the Society, although this is unlikely to affect their benefit expectations.
- 2.6 The security of the existing RM WPSF members will be marginally diluted. However the with profits liabilities are currently very well secured, and after the transfer, assets in excess of the minimum capital resource requirements will exceed 300% of the capital resource requirements.
- 2.7 In taking on additional business from outside the group, additional risks are also accepted, although the main operational risks have already been accepted through the TPA agreement. We consider that the additional risks are not material.
- 2.8 As the scale of the transfer is small, it will have no material effect on the bonus prospects for the Society's members.

3. The Transfer Scheme

3.1 Outline of the Scheme

3.1.1 Changes to policy conditions

The with profits contracts transferring are all long past their maturity dates. The maturity proceeds are held backed by cash on deposit, and the bonus decision process is automatic. Bonuses return the interest earned on the deposits, together with the capital resource requirements released by policies that go off the books. There are no significant free assets held in excess of the capital resource requirements. The contracts are thus, in all but name, unit linked policies investing in a deposit fund where the price is guaranteed never to fall.

The transfer scheme recognises this and converts all with profits policies to unit linked contracts investing in a deposit fund where the price of units is guaranteed never to fall. The deduction for expenses of 0.5% per annum that is currently in the bonus rate determination processes replaced by an annual fund management charge of the same amount deducted from the linked fund.

The transfer scheme allocates the assets currently in the ring fenced sub fund in FAFS to the with profits policies in proportion to the pre-transfer policy values. This means that at the date of transfer the value of assets and liabilities transferred will be equal. There will be no excess assets available to cover capital resource requirements.

3.1.2 Transferred unit linked business

The unit linked business is at present linked to a tax-exempt managed fund with an annual management charge of 0.5%. This will involve a new series of units in our existing tax-exempt fund. The creation of the deposit fund will give policyholders a switching option that they did not previously have.

At present the annual management charge on the unit linked funds is not guaranteed. Were the charge increased, this would be to the direct benefit of the with profits policyholders in the FAFS sub fund. As the benefits of the latter will have guaranteed charges following the transfer, it is reasonable to guarantee the charges on the unit linked policies.

The 0.5% management charge exactly equals the fee that FAFS can charge their Tax Exempt sub fund under the 1990 expense limitation agreement. This means that the unit linked business does not give rise to any surpluses that are available to enhance returns of the with profits policyholders in the sub fund.

3.1.3 Fund structure

As there will be no with profits business involved, a ring fenced sub fund is unnecessary and all the business will be transferred into RM WPSF.

3.1.4 Capital Resource Requirements

Because all the assets in the ring fenced sub fund in FAFS are distributed to policyholders in the transfer, RM WPSF will have to put up the capital resource requirements. The Insurance Capital Requirement is 4% of the with profits liabilities and 1% of the unit linked liabilities. As at 31 December 2007 this is estimated to total £600,000.

The cost of providing this capital support might be assessed as an opportunity cost at a usage charge of 3%, approximately £20,000 per annum.

3.2 Effect on transferring policyholders

It is the primary duty of the Actuary and directors of FAFS to consider the effect of the transfer on their members. The following comments are made in passing, to assist the Society's board in considering the proposals.

3.2.1 Unit linked business

The transfer scheme has no adverse effect on the terms of the unit linked policies. The investment funds will be operated with broadly similar mandates. It is likely that there will be an opportunity to switch from a managed type fund to a deposit fund, which was not previously available, although it is unlikely that many policyholders will use it. The transfer scheme will have no effect on the benefit expectations of these policyholders.

3.2.2 With profits business

The changes outlined above are designed to ensure that the financial effects of the management processes are unchanged before and after the transfer. The new linked funds that will be established for these policies will initially contain the deposit instruments that currently back the liabilities. The fund pricing method replicates the approach currently used to set bonus additions, as documented in Family Assurance's PPFM.

Policyholders will benefit because the excess capital currently in the Tax-Exempt fund within FAFS will be allocated to policies as guaranteed increases in benefits at the point of transfer. Under the current structure this excess capital would only be added to bonuses as the policies run off the books and release the capital resource requirements.

The with profits policyholders are currently exposed to risks arising in their sub fund in FAFS. The main risk is of the default of an asset, as operational risks are largely already assumed by RMIS through the TPA agreement. These risk exposures will be transferred to RMIS because the capital currently used to support the risks is being allocated to policyholders as guaranteed increases in benefit.

3.3 **Effect on RMIS policyholders**

In taking on additional business from outside the Reliance Group, the Society necessarily accepts additional risks. The size of the transfer, the simplicity of the business and the fact that we believe that we are committed to the transfer as a result of agreement in 2004 (albeit unwritten) means that we believe it unnecessary to have a due diligence report prepared by external consultants. The following sections set out the areas where the Society is accepting proportionately greater or different risks from those in our existing portfolio, and the actions taken or proposed to mitigate those risks.

3.3.1 Expenses

The Reliance Group already assumes the expense risk for this business as the administration fees paid to the group for TPA services exactly equal the 0.5% per annum management charges that are levied on the Family Tax Exempt sub fund, and which are replicated by the transfer scheme.

3.3.2 Market and Credit Risk

There are no new market or credit risks from acquiring the FAFS business that are not present in the Society's current business. The additional business transferred will increase the exposure to default of deposit takers, but we believe that our controls in this area are robust.

3.3.3 Operational Risk

The operational risks within the transferred business are mainly within the Reliance Group already, through the TPA agreement. The exception is operational risks connected with investment management, but there are no new issues from this transfer.

As discussed in paragraph 3.1.4 above, RM WPSF will have to put up the capital resource requirements for the transferring business. This has an opportunity cost as the capital is not available to be used elsewhere. If one considers the transfer from cold, then it is difficult to justify the cost against the marginal benefits that might emerge from this transfer as currently structured, compared with the continuation of the current outsourcing agreement.

This approach is invalid because a transfer of the business was agreed in 2004. We believe that the correct approach is to compare the opportunity cost of capital with the costs saved compared with a transfer scheme that made no change to the structure of with profits benefits. Such a scheme would require a separate ring fenced with profits sub fund. This would involve maintaining additional accounting and financial reporting together with setting up with profits governance such as bonus decisions and maintaining a PPFM. On this basis we believe the costs accepted by RMIS policyholders are consistent with the expense savings involved.

There is no effect on RMIS policyholders in WPSF2, WPSF3, WPSF4, WPSF5 or WPSF6.

3.4 Membership and Security

The transferring policyholders will become members of the Society. This is likely to have no material effect on them. They are currently members of one mutual and will be transferring to another.

4. Current and projected financial position of RMIS

4.1 Financial position on statutory reporting basis at the transfer date

The Appendix to this paper sets out the assets, liabilities, solvency margins and financial strength of RM WPSF and the Family Time Tax Exempt sub fund before and after the scheme is implemented, assuming implementation on 31 December 2007. It also shows the effect on the financial position of the Society as a whole.

The Appendix shows the small size of the transfer and the negligible effect that it will have on the overall position of both RM WPSF and the Society. The key figures are:

	RM WPSF £000	RMIS Total £000
<u>Prior to transfer</u>		
Assets in excess of liabilities and capital resource requirements	54,042	65,930
Expressed as a percentage of mathematical reserves	4.51%	4.36%
<u>Following transfer</u>		
Assets in excess of liabilities and capital resource requirements	53,455	65,343
Expressed as a percentage of mathematical reserves	4.41%	4.28%

4.2 Projected development of financial position

As the change in the figures above is so small, we have not carried out projections of the effect of the transfer for future years. The difference between the projected results will reduce as the acquired business runs off. In recent years the off rate, expressed as numbers of policies, has been around 5.5% to 6.0%, although as the contracts are effectively whole life assurances, one might expect this to increase as the population ages.

4.3 Effect of transfer on ICA

We do not believe that this transfer will have any effect on the ICA capital required. The statutory solvency requirement at 4% of mathematical reserves for the bulk of the business is likely to be considerably greater than the capital required on a risk assessed basis. Expense and operational risks will already be covered in our assessment of the group ICA. The additional asset default risk is negligible given the short nature of the deposits placed and the high quality deposit takers used under our general investment guidelines. Thus the solvency capital requirement for this business will have the greater effect.

5. Conclusion

Our conclusion is that the scheme has no adverse effect on the benefit expectations of the RMIS with profits policyholders and no material effect on their security. We also conclude that there are no significant additional risks taken on as a result of the transaction. We believe that the transfer is in the interests of policyholders and should proceed.

TJB/RJH/smc

Statutory Results prior to acquisition and following Family TE fund acquisition

At 31 December 2007

All figures in £000	Pre transfer		Post transfer	Pre transfer		Post transfer
	RM WPSF	TE Fund	RM WPSF	RM Total	TE Fund	RM Total
Long Term Admissible Assets	1,311,971	14,668	1,326,639	1,673,186	14,668	1,687,854
Mathematical Reserves	1,197,475	13,696	1,212,143	1,511,411	13,696	1,526,079
Cost of bonus added	294	666	294	1,319	666	1,319
Current liabilities	36,864		36,864	52,650		52,650
Additional Reserves						
Total liabilities	1,234,633	14,362	1,249,301	1,565,380	14,362	1,580,048
Available Capital Resources	77,338	306	77,338	107,806	306	107,806
LTICR	21,033	561	21,620	33,683	561	34,270
RCR			0	5,930		5,930
CRR of subsidiaries	2,263		2,263	2,263		2,263
Total capital resource req'ts	23,296	561	23,883	41,876	561	42,463
Excess Assets	54,042	-255	53,455	65,930	-255	65,343
as % of CRR	232.0%	-45.5%	223.82%	157.4%	-45.5%	153.88%
as % of mathematical reserves	4.51%	-1.78%	4.41%	4.36%	-1.78%	4.28%