Institute and Faculty of Actuaries

Life Convention 2015 – Dublin
C6: Royal London and CIS – A Case Study

Anthony Lee (Royal London)
and
John Jenkins (KPMG)

Institute
and Faculty
of Actuaries

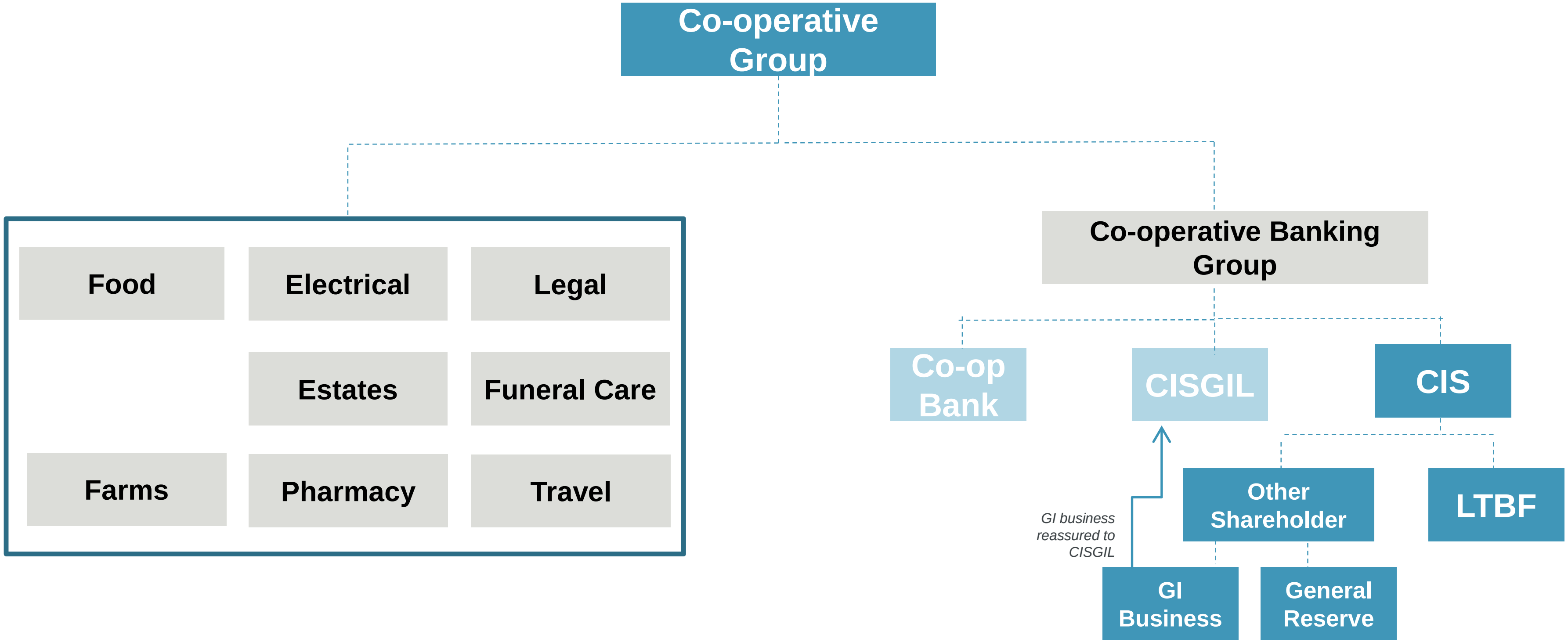
Part A – Anthony Lee (Royal London)

Acquisition considerations

Agenda

- Background to Co-op and CIS
- Components of the deal
- Royal London
- Details of the CIS acquisition
- Financial impacts of the deal
- People
- Personal reflections

Background to Co-op



Background to CIS

- Formed in 1867
- Industrial and Provident Society (IPS) – not a mutual
- Composite insurer (although no general insurance business post 2005)
- General Reserve built up over time
- GI business reassured to CISGIL
- Administration outsourced to Capita in 2007
- Maintenance expenses halved over 5 years up to 2011
- Field sales agents reduced from 6000 to 1000 since 2000
- Bancassurance tie with Co-op Bank

General Reserve

- General Reserve built up from profits of general and life insurance business.
- Transfers in and out of the GR from both businesses.
- Life business net beneficiary over time
- Frozen in 2002 at £317m
- £200m hypothecated to life business in Form 2
- £117m removed in 2011
- Remainder considered as part of the transaction

Components of the initial deal

- Bancassurer channel through Coop Bank and newly acquired Britannia Building Society
  - Deal announced in 2011 to go with AXA
- Field sales channel
  - Closure announce in 2011
- Sale of CIS
- Sale of Co-operative Asset Management (tCAM)
  - Announced Royal London agreed Heads of Terms to buy both CIS and TCAM in 2011

Royal London

- UK’s largest mutual
- Strategy of both organic growth and growth by acquisition
  - Diversified insurance and asset management business
  - Back-book consolidator - history of acquisitions
    - Royal Liver
    - Scottish Life
    - Scottish Provident
    - United Assurance (Refuge and United Friendly)
- Office in the North-West

Details of the CIS acquisition

- SPA agreed in 2013 – share sale from CBG to RL (with IPS conversion)
- TSA – primarily IT services until separation
- Components of the SPA included
  - Expense tariff
  - Exceptional costs
  - Policyholder Protections (IMA, PPFM, Capital Management Policy)
  - Charges for capital support
  - Deferred consideration & General Reserve
  - GI Part VII
  - Mis-selling (default to proprietary treatment)
  - Disclosures & Indemnities

Up to the point of the Part VII

Financial impacts of the deal

- Royal London - £150m benefit from expense tariff and IMA agreement
- Co-operative Banking Group – initial consideration + deferred consideration – £219m in total
- CIS – increase in resources through reduction in technical provisions and reduction in capital requirements via
  - 20 year unit cost tariff fixed at 2011 expense level escalating at avg(RPI,NAE) …. certainty around expenses for policyholders going forwards
  - part of a bigger insurance group (so lower exceptional costs)
  - release from pension scheme liability

People

- All actuarial, finance, investment managers and products TUPE’d to RL (c150 in total)
- TUPE’d staff relocated from Manchester to Wilmslow head office 12 months after acquisition
- RL and CIS actuarial department merged together in 2014 following the Wilmslow move
- Synergies allowed some BAU staff to move onto Solvency 2 programme

Personal reflections

- Proud of working at Co-op – fitted with personal ethics; Royal London is a great match
- First transaction - huge learning curve
- Tripartite discussions (RL, CBG and CIS)
- Awareness of personal acceleration through change compared to my team
- Was involved in the Part VII post TUPE to Royal London

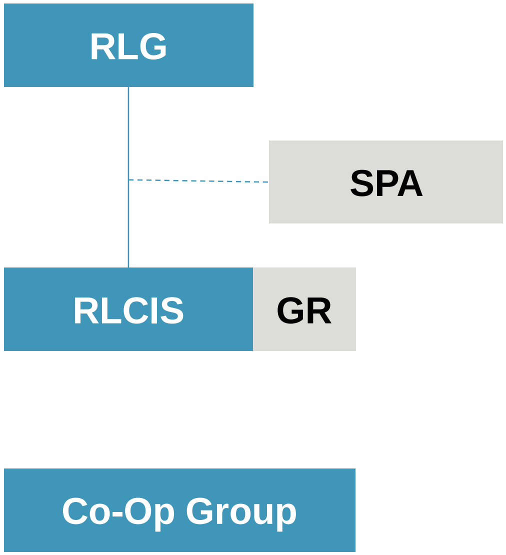
Institute
and Faculty
of Actuaries

Part B – John Jenkins (KPMG)

Part VII transfer and Independent Expert considerations

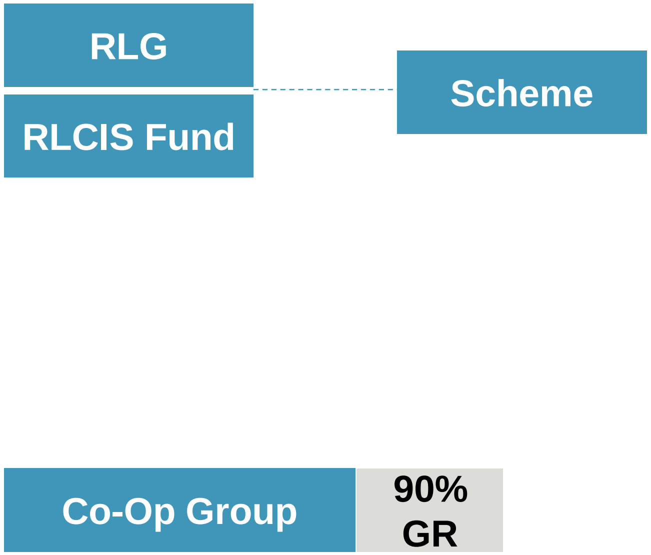
Part VII High Level Overview

Pre-transfer



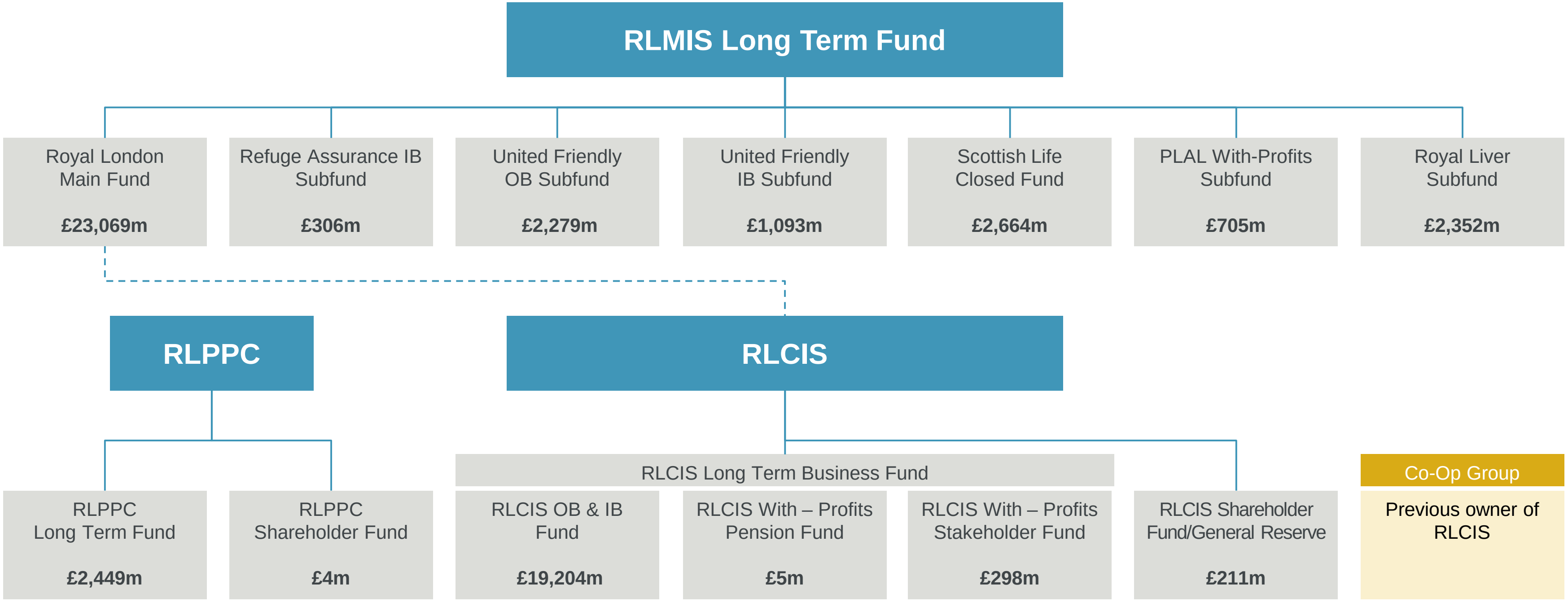
RLCIS – separate legal entity owned by RLG, including the GR

Post-transfer



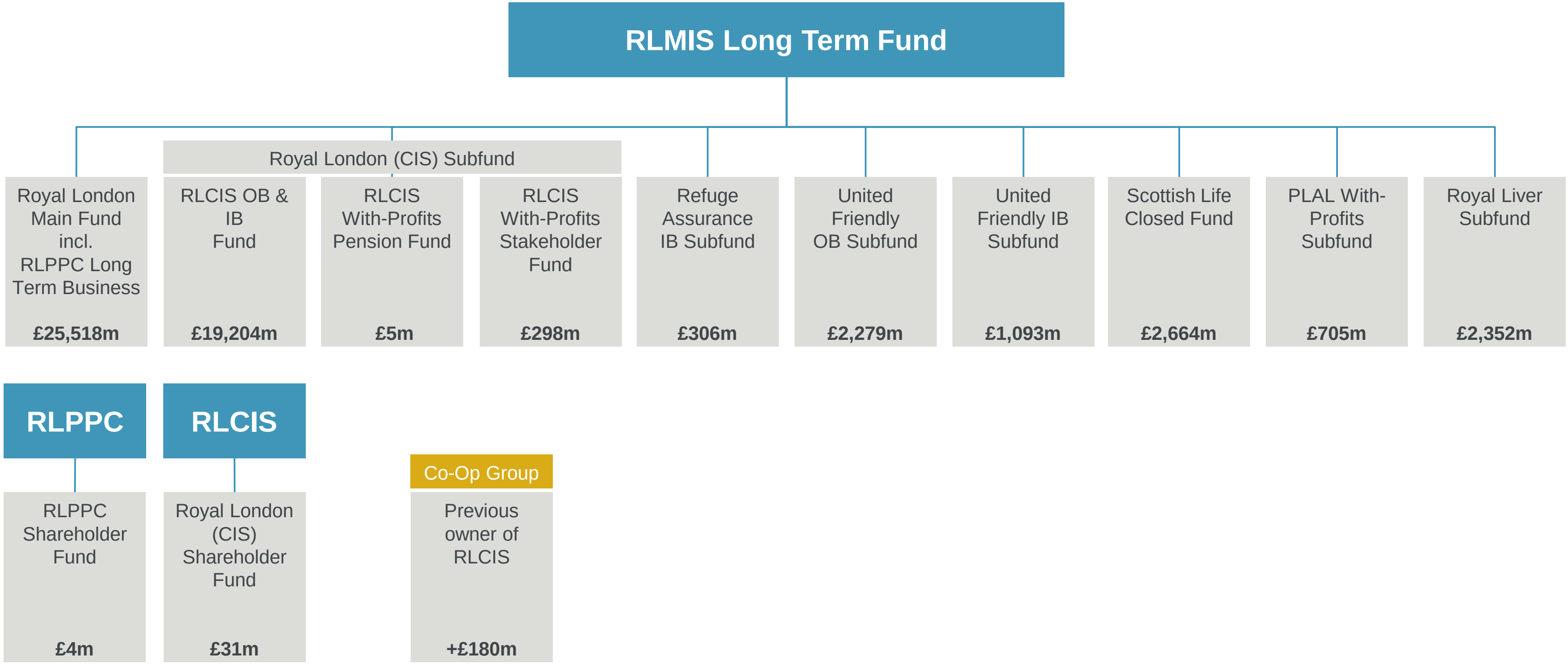
RLCIS – closed sub-fund in RLG, most of the GR returned to Co-Op Group

Pre-transfer – Details



Values at end 2013.

Post-transfer – Details



Values at end 2013.

Part VII – Keys Aspects

- Standard transfer in many respects, but:
    1. SPA extensive, with policyholder protections
        - Some aspects lapsed on transfer
        - Some aspects amended on transfer
        - Some aspects permanent
        - Quite a lot of IE-type work done by CIS WPC/WPA as part of the acquisition
    2. Release of (most of) the General Reserve (GR) back to Co-Op Group
        - Benefit expectations aspect
        - Financial security aspect
        - Unique feature of this case
    3. Non-profit business left in the RLCIS Fund – to be dealt with at a future date
    4. Pension scheme resolved – no further exposure

SPA & Scheme – Expenses, Op-Risk, & Mis-Selling

- **BAU Expenses**
  - Expense tariff with inflation for 20 years
  - Carried from SPA into Scheme
  - IMA for investment expenses
  - Some aspects clarified in Scheme
  - Op-Risk considerations needed clarification in the Scheme
- **Exceptional Expenses**
  - Some principles set out in the SPA, but needed more clarification in Scheme
  - Care needed on certain general development expenses
- **Mis-Selling**
  - Quite complex due to FCA rule change in July 2004
  - SPA principles carried into Scheme
  - Nothing more needed

SPA & Scheme – Capital Support & Charges for Capital Support

Quite a difficult issue for the IE!

Aim/Principle: RLCIS Fund self supporting ✓

Define:

- Type 1 Capital Support: Sub-fund cannot cover its liabilities:
  - Cash/assets injected from the RLMF – regulatory rules (both pre- and post-S2)
  - Repaid if situation recovers (with investment return earned)
  - Permanent if no recovery ('Burnthrough')
- Type 2 Capital Support: Sub-fund can cover its liabilities, but not its capital requirements
  - No requirement/rule to require cash/assets injection into sub-fund
  - But amount of capital requirement 'overspill' encumbered in the RLMF
- Key Questions:
  - Is it reasonable to charge the sub-fund for Type 2 capital support?
  - Is it reasonable to charge the sub-fund for Type 1 capital support (in addition to repaying investment returns)?

SPA & Scheme – Capital Support (continued)

- Arguments in different directions:
  - SPA – Charge for both Type 1 and Type 2, but no precedent explicitly stated for post transfer position
  - Post acquisition PPFM – Reference to Type 1 & Type 2 support, but no reference to charges
  - Previous industry deals/schemes – Generally no charge for Type 2, and investment return only for Type 1, but aware of two exceptions (one RLG, one other)
  - RLMF Mutual Divided Arrangement – Type 2 support deducted , so would reduce/delay dividends
- My Initial view: No – these charges not reasonable. But, on careful thought: Yes, they are reasonable, given the effect on the RLMF and greater recognition that capital has a cost. But provided:
  - Support only where absolutely necessary – maximum use of management actions to extent allowed by PRA
  - Changes borne by the RLCIS estate
  - Charge rate on first slice of support = 0% – to avoid charges in spurious circumstances
- Scheme clarified the above

General Reserve – Benefit Expectations

- RLCIS historically a composite – LTB & GI
- LTBF 100/0, but some transfers to/from G.R. historically
- Only transfers from GR to LTBF since 1976, so GR was supporting the LTBF
- Max of £34m 1999, then phased down to zero by 2008, and zero since 2008

OTHER INPUTS:

Financial Statements	WPG/PPFM	Policy Documents	PRA Returns
Reference to reduction in GR in 2011	Support only in exceptional circumstances	Benefits can be met from GR	£200m allocated to LTBF on Form 2

CONCLUSION:

- A benefit expectation in relation to the GR **did exist**
- But was phased out (with disclosure) during 1999–2008
- No benefit expectation now exists

+ Q.C. came to similar conclusion from legal perspective with different reasoning

Note – IE did not rely on QC opinion

General Reserve – Financial Security

- Proposed removal of GR (to Co-Op Group) relevant for 2 reasons:
  - Effect on financial security of RLCIS Fund post transfer
  - Effect on financial security of RLMIS generally post transfer – both RLMF and Closed Funds

SO, LOOKED AT:

Pillar 1 (RBS)	Pillar 2	Solvency II	Stress 4 Scenario Testing		Guaranteed benefits
Numerical	Commentary (full results available to IE)	Commentary (full results available to IE)	RLG's normal RST	Specific SST for this analysis	Proportion …
				More on next slide	

- So, very extensive analysis, looked at from many perspectives
- Specifically commented on (favourably!) by the judge at the financial hearing

General Reserve – Specific SST

- Approach
  - Work out scenarios which equalises assets and liabilities i.e. reduces estate to zero
  - No allowance for the GR
  - No capital requirements post scenario – deliberately so
  - Non–BAU management actions assumed (e.g. removal of past miscellaneous surplus, reduced EBR)
  - But still 100% of asset shares, post scenario

Scenario A Insurance Risk Scenario	Scenario B Market Risk Scenario	Scenario C Continued Scenario
Zero pension transfers Zero early retirements 100% GAO take up Longevity 5% + trend to 3.5%pa	Equities: -90% Properties: -68% Interest rates: +7%pa Credit spreads: AAA= +7.5%pa BBB = +15.0% pa	Equities and Properties: -20% Internal rates: adverse shape change Transfers/E-rets: 50% reduction GAO take up: 100% for non-trivial Longevityu 7%+ 1.85% trend
All guarantees bite and everyone lives longer	**Bad Market**	**Mixed scenario**

General Reserve – Specific SST

Conclusions:

- In each case (A,B,C) assets are still equal to liabilities – just
- With still some management actions in the bag
- Plus, very comfortable ratio of guaranteed/ total benefits in base scenario

Which leads to:

- "Stresses under which the assets and liabilities of the RLCIS fund would become equal are extremely remote – and for the most part beyond contemplation in terms of all the aspects of the scenario occurring simultaneously."
- "Would thus require events even more extreme for the GR to be called upon to support the RLCIS Fund on a permanent basis."

Summary

Main conclusions then fall into place:

- RLCIS:
  - Benefit expectations OK – no change
  - Financial security OK – no material change
- RLMIS/RLMF
  - Largely follows on as a corollary – both benefit expectations and security
- Other aspects:
  - Service levels, legal risk, 2014 Budget, tax, regulation risk
  - All fairly straightforward
  - 2014 Budget actually helped – could only reduce GAO take up