Report of the Chief Actuary of

The Prudential Assurance Company Limited

on the proposed transfer of the Polish branch and certain other historic overseas business

of

The Prudential Assurance Company Limited

to

Prudential International Assurance plc

pursuant to Part VII of the Financial Services and Markets Act 2000

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REPORT OF THE CHIEF ACTUARY OF THE PRUDENTIAL ASSURANCE COMPANY LIMITED

The following is the report by Stewart Gracie, the Chief Actuary of The Prudential Assurance Company Limited (PAC) to the Directors of PAC on the proposed transfer of the business of the PAC Poland branch (and certain other historic overseas business) ("PAC's European liabilities") to Prudential International Assurance (PIA), a subsidiary of PAC, which is domiciled and regulated in Ireland. The proposed transfer will take place on 1 January 2019, or on such other date as may be agreed by PAC and PIA and approved by the High Court of Justice of England and Wales (the Court).

1. INTRODUCTION

1.1 Prudential has been reviewing its operations across Europe since the UK voted to leave the European Union (EU), which is expected to be on 29 March 2019. Currently Prudential's European operations are split across two companies, PAC and PIA. Prudential has decided to consolidate all of its long-term European life business (excluding the UK) into one entity, PIA, which is based in Ireland.

This change streamlines Prudential's operating model and allows for simpler management structures. An important aspect of this transfer is that it provides flexibility given that post-Brexit there is a risk that PAC, as a UK insurance company, will not be able to service its long-term European life business (excluding the UK) and operate in the same way it has done previously within the EU.

1.2 PAC's presence in Europe is a consequence of both businesses that PAC established in Europe, and as a by-product of acquisitions which PAC has made. In addition Prudential has established various non-insurance businesses in Europe to support its insurance business from both a management services perspective and from a distribution perspective. The business to be transferred includes business written by PAC in Poland, France and Malta as well as business written in Germany and Ireland that was transferred to PAC from the Equitable Life Assurance Society (ELAS) in 2007.

1.3 PIA is a public limited company, the shares of which are 100% owned by PAC. PIA is an Irish regulated entity and is subject to the relevant requirements and guidelines of the Central Bank of Ireland (CBI). In October 2014, PIA established an overseas branch operation, Prudential International Assurance UK Branch (PIA UK Branch), in the United Kingdom.

1.4 PIA is an insurer in the offshore bond market. Its focus is the sale of multi-asset solutions to UK nationals resident in the UK and selected countries in Europe and the Crown Dependencies.

1.5 The purpose of this report is to review the proposed transfer of PAC's European liabilities to PIA. The proposed transfer will take effect by means of an insurance business transfer scheme (the Scheme) under Part VII of the Financial Services and Markets Act 2000 (the FSMA). This report should be read in conjunction with the Scheme.

1.6 In this report, I have considered the transfer from the perspective of policyholders of the business that will be transferred to PIA and the policyholders remaining in PAC following the transfer. I have not considered the perspective of existing policyholders of PIA. The Head of the Actuarial Function (HoAF) of PIA has considered the transfer from the perspective of these policyholders in her report (referenced in section 1.10 below). I have reviewed this report.

1.7 I am a Fellow of the Institute and Faculty of Actuaries, having qualified in 1994, and hold a Chief Actuary certificate issued by the Institute and Faculty of Actuaries.

I have been the PAC Chief Actuary since the date of Solvency II implementation (1 January 2016), and prior to that I held the equivalent role of Actuarial Function Holder, a position which I took up in 2014.

1.8 I am also a shareholder in PAC's ultimate owner, Prudential plc.

1.9 Peter Needleman, the With-Profits Actuary of PAC, has produced a report which considers the proposed transfer from the perspective of PAC's with-profits policyholders.

1.10 The HoAF of PIA, has produced a report which considers the proposed transfer from the perspective of PIA's policyholders.

1.11 Oliver Gillespie of Milliman has been retained by PAC and PIA to produce a report on the terms of the Scheme in the capacity of Independent Expert, and his appointment has been approved by the Prudential Regulation Authority (PRA). A copy of this report has been provided to Mr Gillespie, who has had the opportunity to review various drafts of it.

1.12 This report is structured as follows:

- Section 2 sets out information on the current operation of PAC
- Section 3 sets out information on the current operation of PIA
- Section 4 sets out the financial position of PAC at 31 December 2017
- Section 5 sets out the financial position of PIA at 31 December 2017
- Section 6 sets out details of the proposed transfer
- Section 7 sets out the impact of the proposed transfer on the financial position of PAC assuming that the transfer had taken place on 31 December 2017
- Section 8 sets out the impact of the proposed transfer on the financial position of PIA assuming that the transfer had taken place on 31 December 2017
- Section 9 sets out the impact of the proposed transfer on transferring PAC policyholders
- Section 10 sets out the impact of the proposed transfer on remaining PAC policyholders
- Section 11 sets out my conclusions.

1.13 This report is subject to, and complies with, all relevant Technical Actuarial Standards (TASs) published by the Financial Reporting Council (FRC) in the UK, in particular:

- TAS 100: Principles for Technical Actuarial Work, and

- TAS 200: Insurance.

The intended users of this report are the Court, the Board of Directors of PAC and PIA, the PAC With-Profits Committee, the PAC With-Profits Actuary, the PIA HoAF, the Independent Expert, the PRA, the Financial Conduct Authority (FCA) and the CBI.

A version of this report has also been reviewed by my legal advisors.

1.14 In accordance with Actuarial Profession Standards (APS) issued by the Institute and Faculty of Actuaries, *APS X2: Review of Actuarial Work* requires Members of the profession to consider whether to apply work review to actuarial work for which they are responsible, and whether it would be appropriate and proportionate for this work to be in the form of independent peer review.

I have produced this report in my capacity as the Chief Actuary of PAC, operating in the second line Risk function and as such, providing independent peer review of the proposals provided by the PIA business unit.

The conclusions in section 9.5, 10.6 and 11 are my own and I have sought independent peer review. Jonathan Hughes has provided this review and my report incorporates his feedback. The transaction is also subject to review by an Independent Expert which I believe provides appropriate additional review and challenge.

1.15 The Actuarial Function of PAC is designed to avoid potential conflicts of interest. In particular, the Chief Actuary is a second line role, giving clear segregation between the calculation and oversight of the technical provisions (and other tasks within the remit of the Actuarial Function). During 2017 the potential for conflicts of interest, or the appearance of conflicts of interest, was increased when I took on the first line role of Director of Financial Management, Planning and Performance within the Finance Function of PAC, reporting to the Chief Financial Officer (whilst maintaining the role of Chief Actuary, reporting to the Chief Risk Officer, for a temporary period until a new Chief Actuary is appointed). Additional controls were put in place to address this. For this Part VII transfer, there is no conflict as I am only involved from a Chief Actuary perspective and have recused myself from any first line work, which is being led by PIA.

1.16 This report is an abridged version of a fuller report to the Board of Directors of PAC and PIA on the proposed transfer. The full report includes information that is confidential to the companies and their regulators and is available to the PAC Board, the PIA Board, the PAC With-Profits Committee, the PAC With-Profits Actuary, the PIA HoAF, the Independent Expert, the PRA, the FCA and the CBI in order to assist their assessments of the company’s proposals.

2. INFORMATION ON THE PRUDENTIAL ASSURANCE COMPANY LIMITED

The key elements of the management of PAC's business that are relevant to the consideration of the proposed transfer are set out in sections 2.1 to 2.6 below.

2.1 Company information

2.1.1 PAC is a proprietary company, the shares of which are wholly owned by its immediate parent company, Prudential plc, which is also the ultimate holding company of the Prudential group.

2.1.2 PAC's principal activity is long-term insurance business which includes conventional with-profits, accumulating with-profits, non-linked non-profit and unit-linked business.

2.1.3 PAC has a shareholder fund (PAC Shareholder Fund) and also maintains a long-term insurance fund. PAC's long-term insurance business is written in its long-term insurance fund.

2.1.4 The long-term insurance fund comprises the With-Profits Fund and the Non-Profit Sub-Fund (NPSF) referred to in sections 2.1.5 and 2.1.6 below. There is no regulatory requirement to maintain a long-term insurance fund, however, PAC does so in order to identify for accounting and operational purposes assets and liabilities attributable to its long-term insurance business.

2.1.5 PAC maintains a With-Profits Fund comprised of the following ring-fenced funds: the With-Profits Sub-Fund (WPSF), the Scottish Amicable Insurance Sub-Fund (SAIF) and the Defined Charge Participating Sub-Fund (DCPSF).

2.1.6 The NPSF is maintained for accounting and operational purposes to allow PAC to identify its long-term insurance business which is not allocated to its with-profits funds. The business allocated to the NPSF and the PAC Shareholder Fund, including the subsidiaries owned by the PAC Shareholder Fund, are referred to as the "shareholder-backed" business since the working capital for such business has been provided from the shareholders.

2.1.7 PAC operates as the main insurance company in the UK and Europe business unit of the Prudential group (referred to throughout this report as Prudential UK & Europe). The PAC Shareholder Fund directly owns a number of insurance companies, which are part of Prudential UK & Europe and which are, as at 31 December 2017, listed in Figure 2.1 below.

Figure 2.1 – PAC fund structure

The Prudential Assurance Company limited (PAC)					
Shareholder-backed business			With-Profits		
General Insurance Fund	Other	Non Profit Sub-Fund (NPSF) "0:100"	With-Profits Sub-Fund (WPSF) "90:10"	Scottish Amicable Insurance Fund (SAIF) "100:0"	Defined Charge Participating Sub-Fund (DCPSF) "100:0"

Prudential Pensions Limited (PPL)
Prudential International Assurance plc (PIA)
Prudential Holborn Life Limited (PHLL)
Prudential Hong Kong Limited (PHKL)
Prudential General Insurance Hong Kong Limited (PGHK)

2.1.8 The numerical descriptions of the sub-funds in Figure 2.1 above refer to the basis of allocation of the profits that are declared for distribution amongst with-profits policyholders, or for transfer to the PAC Shareholder Fund; thus:

(i) no less than 90% of any such profits attributable to the WPSF are allocated to the with-profits policyholders, with the balance being available to be transferred to the PAC Shareholder Fund. The WPSF is therefore described as a 90:10 sub-fund;

(ii) 100% of any such profits attributable to SAIF and the DCPSF are allocated to the with-profits policyholders. These funds are therefore described as 100:0 sub-funds; and

(iii) 100% of any such profits attributable to the NPSF, with the exception of surplus generated in respect of the protection business written under the PruProtect white label agreement (the profits of which do not belong to PAC), are available to be transferred to the PAC Shareholder Fund. The NPSF is therefore described as a 0:100 sub-fund.

2.1.9 In August 2017, Prudential plc announced that it was combining two businesses within the Prudential group, Prudential UK & Europe and its asset manager, M&G, to form a combined business called M&G Prudential.

In March 2018, it was announced that M&G Prudential would demerge from the Prudential group, resulting in two separately listed companies. It was also announced in March 2018 that PAC had entered into a transaction to transfer a portion of the shareholder-backed non-profit annuity business to Rothesay Life Plc (Rothesay). Under the terms of the agreement, PAC reinsured a portion of liabilities to Rothesay, through a collateralised reinsurance arrangement, with the intention that this is followed by a Part VII insurance business transfer of the business by the end of 2019. Finally, to align the ownership of Prudential plc’s businesses with their operating structures, Prudential plc announced that it intends to transfer the legal ownership of its Hong Kong insurance subsidiaries from PAC to Prudential Corporation Asia Limited (PCA), another subsidiary of Prudential plc, by the end of 2019.

2.2 With-profits business

2.2.1 PAC's with-profits business is written in three sub-funds:

2.2.2 <u>The With-Profits Sub-Fund (WPSF)</u>

The WPSF consists mainly of with-profits business, which comprises:

(i) business written by PAC, both Ordinary Branch (OB) (including business written in Poland and Malta) and Industrial Branch (IB),

(ii) business written by Scottish Amicable Life plc (SAL), and subsequently transferred into PAC, and

(iii) business written by Prudential (AN) Limited (PANL), and subsequently transferred into PAC.

The WPSF also contains some non-profit business, which consists of:

(i) the non-profit (including unit-linked) business written by PAC in the UK that is not allocated to the NPSF,

(ii) certain types of business originally written by the Scottish Amicable Life Assurance Society (SALAS) and now allocated to the Scottish Amicable Account (SAA) in the WPSF,

(iii) non-profit pension annuity business arising from with-profits pension policies choosing to vest their annuities internally with PAC. This business was previously reinsured to Prudential Annuities Limited (PAL), but was recaptured in August 2011, and

(iv) non-profit pension annuity business which was transferred into the WPSF from PAL by means of a Part VII transfer on 1 October 2014.

2.2.3 <u>The Defined Charge Participating Sub-Fund (DCPSF)</u>

The DCPSF comprises:

(i) business reinsured into PAC from PIA or other companies,

(ii) business written through PAC's French branch (between 1 January 2001 and 31 December 2003), and

(iii) the business transferred from ELAS on 31 December 2007.

2.2.4 <u>The Scottish Amicable Insurance Fund (SAIF).</u>

SAIF is a closed sub-fund that contains the bulk of the business originally written by SALAS and transferred to PAC on 30 September 1997 under a scheme made under Schedule 2C to the Insurance Companies Act 1982 in relation to the demutualisation of SALAS (the SALAS Scheme).

2.2.5 Risk Appetite

2.2.5.1 The PAC Board is responsible for the management of the company's long-term insurance business, including its exposure to risk.

2.2.5.2 In managing risk, the PAC Board is responsible for:

(i) determining the company's risk appetite. This, in conjunction with the company's available capital, determines the company's risk capacity from time to time; and

(ii) managing the overall risk level of the company and the long-term insurance fund, including its four sub-funds, having regard to that risk capacity.

2.2.5.3 The company's current risk appetite, as determined by the PAC Board is summarised as follows:

(i) a 1 year regulatory solvency risk appetite statement for the WPSF (based on Solvency II, Pillar 1 capital requirements);

(ii) a claims paying risk appetite statement for the WPSF (based on Solvency II, Pillar 2 capital requirements);

(iii) four solvency coverage zones which link to both a Solvency Intervention Ladder (SIL) that specifies the monitoring, reporting and/or escalation that should take place in each of the zones and the With-Profit Management Framework (WPMF);

2.2.5.4 In order to ensure that the company's operations remain within its risk capacity, the PAC Board manages the types and volumes of new business accepted (particularly in relation to the guarantees given), and sets the bonus and investment policy of its with-profits business, having regard to the available capital in the long-term insurance fund.

2.2.6 PAC Pension Mis-selling Costs Assurance

2.2.6.1 The PAC inherited estate bore the costs associated with the PAC personal pensions mis-selling review. In order that the resulting reduction in the PAC inherited estate would have no adverse impact on policyholders, an assurance was given in July 1998, referred to as the "PAC Pension Mis-selling Costs Assurance", that deducting personal pension mis-selling costs from the PAC inherited estate would not have an adverse effect on the level of bonus paid to policyholders or their reasonable expectations, and that in the unlikely event of this proving not to be the case, the intention was that an appropriate contribution to the long-term insurance fund would be made from shareholders' funds for as long as the situation continued.

2.2.6.2 The assurance was designed to protect both existing WPSF policyholders at the date it was announced, and policyholders who subsequently purchased policies while the pension mis-selling review was continuing. The review was completed on 30 June 2002, and consequently the assurance has not applied to new WPSF business issued since 31 December 2003. The assurance continues to apply to all WPSF policies that were in force as at 31 December 2003, both for premiums paid before 1 January 2004 and for subsequent regular premiums. An appropriate proportion of the assurance was allocated to PAC's Hong Kong subsidiary, Prudential Hong Kong Limited

(PHKL), following the transfer of the Hong Kong with-profits business from PAC to PHKL on 1 January 2014.

2.2.6.3 Following the implementation of a Capital Support Arrangement (CSA) between Prudential plc and PAC, as discussed in section 2.6.1 below:

(i) PAC is responsible for ensuring that the assurance is honoured, so that the charging of pension mis-selling costs to the WPSF does not have an adverse effect on the levels of bonus paid to policyholders or to their reasonable expectations. PAC is also responsible for ensuring that any capital support that is necessary to honour the assurance is provided to the WPSF from the PAC Shareholder Fund; and

(ii) subject to the terms of the CSA, Prudential plc is responsible for ensuring that PAC is provided with necessary capital support, beyond the resources of the PAC Shareholder Fund, including that which might be required to support the PAC Pension Mis-selling Costs Assurance. Any such support that is required by PAC from Prudential plc under the assurance would be provided under the CSA.

2.3 Shareholder-backed business

2.3.1 As discussed in section 2.1.7 above, the PAC Shareholder Fund owns a number of insurance companies, including PPL, PIA and PHKL.

2.3.2 The NPSF consists of such non-profit and unit-linked business as has been allocated to this sub-fund, and includes business written in the UK and Poland.

The NPSF includes the non-profit and unit-linked business of PANL and Prudential Holborn Life Limited (PHLL) that was transferred into PAC on 31 October 2010.

The NPSF also includes all of PAC's Defined Charge Participating business, apart from the business which was transferred from ELAS. The investment element of the Defined Charge Participating business held in the NPSF is allocated to the DCPSF. All management charges for the Defined Charge Participating business held in the NPSF are credited to the NPSF, which bears all of the expenses of this business.

The business transferred from ELAS is allocated to the DCPSF, however, the NPSF bears all the expenses of this business and, in return, receives an annual management charge that is applied to the ELAS asset shares.

2.3.3 The non-profit annuity liabilities in the NPSF include:

(i) annuities originally written in SAL that were subsequently transferred to PAC via a Part VII transfer in 2002;

(ii) directly written PAC NPSF annuities; and

(iii) annuity liabilities originally written in Prudential Retirement Income Limited (PRIL) that were subsequently transferred to PAC via a Part VII transfer in 2016.

2.3.4 In recent years, PAC has reinsured the longevity risk on a material proportion of non-profit annuity liabilities through reinsurance arrangements in the form of longevity swaps with several counterparties. These reinsurance arrangements do not cover any of the transferring policies and will therefore not be impacted by the proposed transfer.

2.4 PAC's European liabilities

2.4.1 The Prudential Assurance Company Limited Sp. z o.o. Oddział w Polsce (PAC Poland) was set up in 2012 as a local Polish branch of PAC. The branch's business comprises conventional with-profits, regular premium endowments, protection rider benefits and standalone term assurance plus riders. As at 31 December 2017, there are 22 sales offices and a tied agency salesforce of around 933 agents. Simple protection products are sold via telephone to customers of partners such as telecommunication companies (Affinity). Prudential products are also sold through multi-agencies and a bancassurance channel which sell a variety of products from various insurers.

2.4.2 PAC Poland has an existing reinsurance arrangement with Swiss Re in the form of a quota share reinsurance arrangement, reinsuring a portion of the following:

(i) the mortality risk in respect of PAC Poland's non-profit protection business; and

(ii) the non-profit riders and the mortality risk of PAC Poland's with-profits business.

2.4.3 The PAC Poland branch was set up with funding provided by the PAC WPSF's inherited estate and by the PAC Shareholder Fund. The funding provided by the inherited estate is repaid by deductions from asset shares of PAC Poland branch policyholders, with interest equal to the expected return on asset shares in the PAC Poland branch. The PAC Board has agreed that the PAC Shareholder Fund should provide an underpin to the funding provided by the inherited estate, whereby any outstanding funding (after allowing for the present value of future charges expected to be recovered from the business then in-force) 12 years after the launch of the Poland branch will be repaid to the inherited estate by the PAC shareholder (the 12 year term is potentially extendable by a further 3 years). The terms of the underpin also provide that the underpin repayment will become payable immediately if the PAC Branch closes prior to the 12 year point.

2.4.4 Prudential Polska Sp. z o.o. (Prudential Polska) is a local Polish entity which acts as an agent for PAC Poland and manages the general agency sales force. It is a fully-owned subsidiary of Prudential Financial Services Ltd (PFSL) which is in turn a fully-owned subsidiary of Prudential plc.

2.4.5 PAC established a branch and began writing business in France in 2000. The PAC France branch (PAC France) ceased writing new business in 2003 but remains open to top-up business from existing policyholders. There are 769 policies remaining in the branch with liabilities of c.£44m as at 31 December 2017. These policies are all single premium bonds which are invested in a mix of with-profits and unit-linked funds. Since its inception PAC France has been administered by Prudential International Management Services (PIMS), an Irish domiciled non-regulated services company fully owned by PAC, under a delegated authority. In addition, an outsourcing arrangement was set up between PIMS and Capita Life and Pensions Services (Ireland) Limited (CLPSI) to provide the relevant services.

2.4.6 PAC established a branch in Malta in 1955, writing business through a direct sales force. The branch ceased writing business in 1982 and has been in run off since. As at 31 December 2017, PAC Malta has 21 policies remaining, made up of 17 whole of life with-profits policies and 4 non-profit whole of life insurance policies. The business is currently administered by Prudential Distribution Limited (PDL) and PIA's Managing Director exercises a delegated authority over the business. There is a reinsurance arrangement between PAC Malta and Swiss Re covering two high value with-profits whole of life PAC Malta policies.

2.4.7 The former ELAS business in the DCPSF, described in section 2.2.3, included a small number of policies which were originally written by overseas branches of ELAS. As at 31 December 2017, this business was made up of 439 with-profits annuity contracts which were originally written in Germany and 237 with-profits annuity contracts which were originally written in Ireland. All of the former ELAS business (including that written in Germany and Ireland) is currently administered on PAC's behalf by Equiniti.

2.5 Risk Appetite

2.5.1 PAC's shareholder risk appetite (SRA) incorporates a 'twin peaks' approach, with Solvency II, Pillar 1 capital requirements forming the regulatory peak, and Solvency II, Pillar 2 Economic Capital (ECap) forming the management peak.

2.5.2 A series of thresholds are defined as part of a Solvency Intervention Ladder. When these thresholds are breached, a series of management actions are considered to restore the SRA capital buffer.

2.6 Capital support arrangements

2.6.1 Prudential plc and PAC have entered into a formal, legally enforceable CSA , under which Prudential plc has an obligation to provide PAC with additional capital support up to a maximum level, when it is notified that PAC's solvency has fallen below specified levels. The capital support provided under the CSA includes the capital support that might be required to support the PAC Pension Mis-selling Costs Assurance in relation to with-profits business.

3. INFORMATION ON PIA

3.1 Background

3.1.1 PIA is a public limited company, the shares of which are 100% owned by PAC. As an Irish regulated entity, PIA is subject to the Solvency II regulatory regime, applicable to all EU entities, as well as to the relevant requirements and guidelines of the CBI. In October 2014, PIA established an overseas branch operation, Prudential International Assurance UK Branch (PIA UK Branch), in the United Kingdom.

3.1.2 PIA is an insurer in the offshore bond market. Its focus is the sale of multi-asset solutions to UK nationals resident in the UK and selected countries in Europe and the Crown Dependencies.

3.1.3 PIA's current markets outside of the UK include France, Spain, Malta, Cyprus, Gibraltar and the Crown Dependencies (Isle of Man, Jersey, and Guernsey). PIA has two lines of business: unit-linked insurance and insurance with-profit participation. Insurance with-profit participation business comprises all single premium investment products that are invested in the PAC with-profits funds via a reinsurance arrangement.

3.1.4 The PIA UK Branch was established in the UK in October 2014 under the EU freedom of establishment rules. The business sells single premium insurance bonds and targets high net worth individuals seeking the tax and estate planning advantages offered by an onshore bond.

3.1.5 The PIA UK Branch sells only unit-linked insurance business (onshore bonds).

3.2 Risk Appetite

3.2.1 The PIA Board is responsible for the management of the company, including its exposure to risk.

3.2.2 In managing risk, the PIA Board is responsible for:

(i) determining the company's risk appetite. This, in conjunction with the available capital, determines the company's risk capacity from time to time, and

(ii) managing the overall risk level of the company, having regard to that risk capacity.

3.2.3 PIA manages its business to a target solvency ratio as determined by the company under the Solvency II, Pillar 1 basis. It also has a minimum absolute capital buffer and a minimum solvency ratio.

3.3 Investment management

3.3.1 The PIA Board is responsible for setting PIA's investment strategy which it does through PIA's investment policy. The investment policy sets out the framework for the management and oversight of investment performance and investment related risk for internally and externally managed funds, both policyholder and shareholder.

3.3.2 Investments are made in accordance with PIA's investment policy which is set in line with its risk appetite from an investment and credit risk exposure perspective, and is reviewed annually. PIA monitors its exposures on an ongoing basis, highlighting deviations from its risk appetite through its escalation processes.

3.3.3 Constraints are placed on the credit quality of PIA's assets, and reserves are held to protect the company against the risk of adverse credit experience.

3.4 Reinsurance arrangements

3.4.1 PIA's existing with-profits business is reinsured into the PAC DCPSF. This reinsurance arrangement transfers all investment risk, apart from an immaterial amount associated with death benefit for cases that involve actuarial funding, into the DCPSF.

3.4.2 PIA has in place a number of outwards reinsurance arrangements with Swiss Re L&H, Swiss Re (UK) Ltd, Cologne Re (Dublin) Ltd and General Re Corporation reinsuring a proportion of the risks relating to certain policies in PIA. Following the proposed transfer there will be no change to these reinsurance arrangements.

4. FINANCIAL POSITION OF THE PRUDENTIAL ASSURANCE COMPANY LIMITED

4.1 The financial strength of PAC is measured on a Solvency II basis. In order to demonstrate that the company's business is solvent on this measure, it is necessary to have surplus capital in excess of the SCR.

4.2 The Solvency II regulations allow a transitional measure to be applied to the Solvency II technical provisions. The Transitional Measure on Technical Provisions (TMTP) was originally determined based on the Solvency I, Pillar 2 valuation at 31 December 2015 and the Solvency II valuation at 1 January 2016. As allowed by the regulations, the TMTP was recalculated at 31 December 2017. The figures in this report reflect the TMTP recalculated at 31 December 2017.

4.3 Solvency II

4.3.1 The solvency of PAC on the Solvency II valuation basis as at 31 December 2017 is shown below.

Figure 4.1 – Reported PAC Solvency II valuation results at 31 December 2017

	PIA[(1)] **£m**	**Total PAC shareholder-backed business £m**	**Total PAC With-Profits Fund**[(2)] **£m**
Assets	6,752	77,291	132,826
Best Estimate Liabilities	6,401	57,204	115,632
Risk Margin (net of TMTP)	44	1,452	726
Other Liabilities	104	4,636	6,889
Own Funds	**203**	**13,999**	**9,578**
SCR	130	7,884	4,775
Surplus	**74**	**6,115**	**4,803**
Solvency ratio	157%	178%	201%

Notes:

(1) The results shown do not include the contribution from PIMS for consistency with results presented by PIA. Typically, within PAC (for example in valuation reports for the PAC Board), consolidated results for PIA and PIMS are presented. If results for PIMS were to be included, then the assets, best estimate liabilities, own funds, surplus and solvency ratio would be £6,756m, £6,404m, £204m, £74m and 157% respectively.

(2) This represents an economic view of the Solvency II balance sheet for the with-profits business. The presentation required by the Solvency II regulations excludes the liability (and associated capital requirements) related to the present value of the future shareholder transfers. Applying the regulatory presentation, the Solvency II surplus for total PAC With-Profits Fund, after the application of the TMTP, is c.£7.8bn.

4.3.2 It can be seen that at 31 December 2017, the surplus for the total PAC shareholder-backed business was £6,115m, with an overall solvency ratio of 178%. The surplus for the total PAC With-Profits Fund at 31 December 2017 was £4,803m, with an overall solvency ratio of 201%.

4.3.3 As discussed in section 2.1.9 above, PAC has entered into a transaction to transfer a portion of the shareholder-backed non-profit annuity business to Rothesay. Allowing for this transaction, the solvency position of PAC on the Solvency II valuation basis as at 31 December 2017 (assuming a recalculation of the TMTP) is as follows:

Figure 4.2 – Restated PAC Solvency II valuation results at 31 December 2017

	PIA[(1)] £m	Total PAC shareholder-backed business £m	Total PAC With-Profits Fund[(2)] £m
Assets	6,752	78,556	132,826
Best Estimate Liabilities	6,401	58,826	115,632
Risk Margin	44	1,366	726
Other Liabilities	104	4,554	6,889
Own Funds	**203**	**13,810**	**9,578**
SCR	130	7,143	4,775
Surplus	**74**	**6,666**	**4,803**
Solvency ratio	157%	193%	201%

Notes:

(1) The results shown do not include the contribution from PIMS for consistency with results presented by PIA. Typically, within PAC (for example in valuation reports for the PAC Board), consolidated results for PIA and PIMS are presented. If results for PIMS were to be included, then the assets, best estimate liabilities, own funds, surplus and solvency ratio would be £6,756m, £6,404m, £204m, £74m and 157% respectively.

(2) This represents an economic view of the Solvency II balance sheet for the with-profits business. The presentation required by the Solvency II regulations excludes the liability (and associated capital requirements) related to the present value of the future shareholder transfers. Applying the regulatory presentation, the Solvency II surplus for total PAC With-Profits Fund, after the application of the TMTP, is c.£7.8bn.

4.3.4 The proposed transfer of PAC's European liabilities (as detailed in section 6) involves a transfer of non-profit business from the NPSF and with-profits business from the DCPSF and WPSF to PIA, which forms part of the aggregate PAC shareholder-backed business. PIA solvency is covered in more detail in section 5.

4.4 Risk Appetite

4.4.1 PAC's internal risk appetite position (determined in accordance with the risk appetite statements set out in sections 2.2 and 2.5 above) is not published. However, PAC was appropriately capitalised relative to its risk appetite at 31 December 2017.

4.5 Current solvency position

4.5.1 The impact of the Part VII transfer is not expected to change materially if assessed at 31 March 2018 compared to the assessment at 31 December 2017.

4.6 As discussed in section 2.1.9, in August 2017 Prudential plc announced the merger of Prudential UK & Europe and M&G to form a combined business called M&G Prudential. On the basis of the information available to me, I do not expect the merger to have any impact on the conclusions in this report.

5. FINANCIAL POSITION OF PIA

5.1 The financial strength of PIA is also measured on a Solvency II basis. In order to demonstrate that the company's business is solvent on this measure, it is necessary to have surplus capital in excess of the SCR.

5.2 Solvency II

5.2.1 The solvency of PIA on the Solvency II valuation basis as at 31 December 2017 is shown below.

Figure 5.1 – PIA's Solvency II valuation results at 31 December 2017(1)

	31 December 2017 £m
Assets	6,752
Best estimate liabilities	6,401
Risk margin	44
Other liabilities	104
Own Funds	**203**
SCR	130
Surplus	**74**
Solvency ratio	157%

Notes:

(1) The results shown do not include the contribution from PIMS for consistency with results presented in PIA. Typically, within PAC (for example in valuation reports for the PAC Board), consolidated results for PIA and PIMS are presented. If results for PIMS were to be included, then the assets, other liabilities, best estimate liabilities, surplus and solvency ratio would be £6,756m, £6,404m, £204m, £74m and 157% respectively.

5.2.2 The Solvency II surplus for PIA was £74m at 31 December 2017. There is no TMTP for PIA. The solvency ratio at 31 December 2017 was 157%; this is higher than the target capital ratio of 150%, referred to in section 3.2.4 above.

5.3 Current Solvency Position

5.3.1 The impact of the Part VII transfer is not expected to change materially if assessed at 31 March 2018 compared to the assessment at 31 December 2017.

6. THE PROPOSED TRANSFER

6.1 Proposed transfer

6.1.1 It is proposed that PAC's European liabilities (as detailed in section 2.4 above) should be transferred to PIA. The proposed transfer will take effect by means of an insurance business transfer scheme (the Scheme) under Part VII of the Financial Services and Markets Act 2000 (FSMA). This report should be read in conjunction with the Scheme.

6.1.2 Following the transfer it is expected that the PAC Poland branch, the PAC France branch and the PAC Malta branch will cease to transact insurance business. The PAC Poland branch will not be closed as it may be necessary for it to remain open as a shared services centre.

6.1.3 PIA proposes to pay for the transferred business through the issue of one or more additional shares in PIA to PAC, subject to the terms of a subscription agreement entered into between PIA and PAC that will take effect on the transfer date.

6.2 Business to be transferred

6.2.1 The business to be transferred from PAC to PIA under the Scheme comprises the following (figures are shown as at 31 December 2017):

(i) the with-profits business from PAC Poland, as described in section 2.4.1 above, with asset shares of c.£3m;

(ii) the non-profit business from PAC Poland described in section 2.4.1 above, which has a negative liability of c.£18m (reflecting the fact that the value of future charges exceeds expenses).

There are approximately 18,000 active with-profits policies and 27,000 active non-profit policies in PAC Poland;

(iii) all of the business of PAC France, as described in section 2.4.5 above, comprising approximately 769 policies and liabilities of c.£44m;

(iv) all of the business of PAC Malta, as described in section 2.4.6 above, comprising 21 policies and liabilities of c.£4m; and

(v) policies that were originally written by ELAS in Germany and Ireland, as described in section 2.4.8 above:

(a) 237 with-profits annuity contracts originally written in Ireland, with a liability of c.£11m;

(b) 439 with-profits annuity contracts originally written in Germany, with a liability of c.£13m.

6.3 Rationale for the transfer

6.3.1 Prudential has been reviewing its operations across Europe since the UK voted to leave the European Union (EU), which is expected to be on 29 March 2019. Currently Prudential's European operations are split across two companies, PAC and PIA. Prudential has decided to consolidate all of its long-term European life business (excluding the UK) into one entity, PIA, which is based in Ireland.

6.3.2 This change streamlines Prudential's operating model and allows for simpler management structures. An important aspect of this transfer is that it provides flexibility given that post-Brexit there is a risk that PAC, as a UK insurance company, will not be able to service its long-term European life business (excluding the UK) and operate in the same way it has done previously within the EU.

6.4 Effective date of transfer

6.4.1 If the Scheme is sanctioned by the Court, the transferring policies (along with the associated assets and liabilities) and the corresponding assets noted in section 6.5 below will transfer from PAC to PIA at 00.01 hrs (GMT) (01:01 hrs (CET)) on 1 January 2019, or such other time and date as may be agreed by PAC and PIA and approved by the Court.

6.5 Allocation of assets and liabilities

6.5.1 It is intended that the business described in section 6.2.1 will be transferred to PIA. As a result, any liability (excluding the ELAS mis-selling liabilities) that is attributable to the transferring business will be allocated to PIA. The ELAS mis-selling liabilities have been excluded from the transfer as these would be covered by ELAS under the conditions of the Part VII transfer of the ELAS business to PAC.

6.5.2 Assets attributable to the transferring business will also be transferred to PIA. This includes:

(i) for unit-linked business, assets corresponding to the face value of the units;

(ii) for non-linked non-profit business, assets corresponding to the underlying Solvency II technical provisions held by PAC; and

(iii) for with-profits business, assets corresponding to the asset shares and net cost of guarantees and smoothing (except in respect of the with-profits business of PAC Poland, where smoothing is not applied).

6.5.3 Reinsurance arrangements will be set up to reinsure the with-profits business back to PAC. This is covered in more detail in sections 6.6.2 and 6.6.3 below.

6.6 Reinsurance arrangements

6.6.1 If the Scheme were to be implemented, the existing arrangements between PAC and Swiss Re set out in section 2.4.2 above will be amended as follows:

(i) the reinsurance arrangements will be transferred to PIA pursuant to the Scheme with no other changes to the terms and conditions and the corresponding reinsurance asset will be allocated to PIA; and

(ii) the part of the arrangement in respect of the mortality risk on the with-profits business would be novated back to PAC (together with the corresponding reinsurance assets) immediately after the Scheme becomes effective as the risk will remain with PAC by virtue of the reinsurance arrangement to be set up between PIA and PAC as described in section 6.6.2 below.

The reinsurance arrangements between each of PAC and PIA with Swiss Re will continue to cover future new business written in Poland in accordance with the existing terms of the current Swiss Re treaty.

The existing treaty between PAC and Swiss Re set out in section 2.4.6 for PAC Malta business will remain unchanged as the PAC Malta with-profits business will be reinsured back into PAC upon the proposed transfer.

6.6.2 A reinsurance treaty will be set up to reinsure the Polish with-profits business into the WPSF. This will cover business transferred from PAC to PIA and new business written by the new PIA Poland branch (described in section 6.11(i) below). The intention is that Polish policyholders will continue to have access to the same underlying assets and with-profits proposition that they currently have.

In particular, in line with the current with-profits offering available to Poland, the transferring Polish with-profits business will be reinsured into two distinct Polish asset pools currently held within the PAC WPSF that offer different strategic asset allocations, one with a 25% equity backing ratio (EBR), the other offering a 50% EBR. The business written under the reinsurance treaty will be managed on a basis that is consistent with existing Polish with-profits business within the PAC WPSF. As part of the arrangement, PIA will receive the policy benefits from PAC and will be required by the Scheme to pay bonuses to policyholders in line with those determined by PAC. The arrangement is set up to ensure that the reasonable expectations of the transferred policyholders are maintained and to also protect the interests of other PAC policyholders and the estate.

To protect the interests of the policyholders, the circumstances in which the treaty can be terminated is limited and the terms of any termination will (subject to limited exceptions) be subject to the agreement of an independent actuary and the With-Profits Committee of PAC (or any replacement or successor committee), whose role will be to ensure that no policyholders are materially disadvantaged in this scenario.

6.6.3 Similar reinsurance treaties will be put in place between PIA and PAC in respect of PAC France, PAC Malta, and the business previously written by ELAS to reinsure the corresponding with-profits business back into the respective PAC with-profits funds. Like the PAC Poland reinsurance treaty described in section 6.6.2 above, the reinsured business will be managed on a basis that is consistent with how they are currently managed in the respective PAC with-profits funds.

6.7 Capital support arrangements

6.7.1 As described in section 2.4.3 above, the WPSF provided initial and ongoing funding to the PAC Poland branch. The accumulated level of funding plus interest is due to be repaid to the WPSF within 12 years by way of charges levied on with-profits policies written by the PAC Poland branch (the 12 year term is potentially extendable by a further 3 years). In the event that the charges received by the WPSF are not sufficient to repay the accumulated funding provided then the PAC shareholder fund would be responsible for the outstanding balance to protect the WPSF inherited estate from loss; this is referred to as the Polish shareholder underpin.

6.7.2 Following the Part VII transfer, the WPSF will continue to provide this funding as part of the reinsurance arrangement described in section 6.6.2 above, and the PAC shareholder fund will continue to provide the underpin to the WPSF to protect it from loss.

6.8 PAC Pension Mis-selling Costs Assurance

As discussed in section 2.2.6 above, an assurance was given in July 1998 that deducting personal pensions mis-selling costs from the PAC inherited estate would not have an adverse effect on the level of bonus paid to policyholders or their reasonable expectations, and that in the unlikely event of this proving not to be the case, the intention was that an appropriate contribution to the long-term insurance fund would be made from shareholders' funds for as long as the situation continued.

As a result of the reinsurance arrangements being set up to reinsure the transferring with-profits business back to the respective with-profits funds (as described in sections 6.6.2 and 6.6.3 above), it is expected that policyholders who were originally covered by the assurance will continue to benefit from it following the transfer. The nature of the assurance is expected to remain unchanged.

6.9 Costs

6.9.1 The costs of the Part VII transfer in relation to PAC Poland and the closure of the PAC Poland branch to new business will be allocated to PAC Poland, with these costs being allocated between the WPSF and NPSF in proportion to the current mix of sales volumes of 66%/34% (in line with the current PAC Poland cost allocation methodology).

6.9.2 The costs of the Part VII transfer associated with the transfer of the non-Polish European business (including that in relation to closing the PAC France branch) will be allocated to the NPSF of PAC.

6.9.3 The majority of the costs involved in setting up the PIA Poland branch will be allocated to the new branch with the exception of the project governance and support costs being incurred by PIA. The costs incurred by the PIA Poland branch will be allocated between the WPSF and PIA in the proportion 66%/34%, in line with how the PAC Poland costs are allocated between the WPSF and the NPSF.

6.9.4 The costs associated with considering the Brexit strategy will be allocated to PIA.

6.9.5 The costs allocated to the WPSF will be added to the balance of funding provided by the PAC WPSF that is subject to the Polish shareholder underpin described in section 2.4.3 above.

6.10 Tax

6.10.1 The proposed transfer is not expected to have a material impact on the tax position of PAC in aggregate since the profits and losses of the various branches are already outside the scope of UK tax.

6.10.2 Policyholder taxation from the perspective of transferring and remaining policyholders are covered in sections 9.4.2 and 10.5.4 below.

6.11 Servicing

The servicing arrangements for the policies following the transfer will be:

(i) For PAC Poland, a new PIA Poland branch (Prudential International Assurance plc Spółka Akcyjna Oddział w Polsce) will be set up and the intention is to replicate the processes, governance and controls that apply within the current PAC Poland branch. The PIA Poland branch manager will have delegated authority from the PIA Board for the day to day running of the PIA Poland branch, and will have a direct reporting line to PIA's Managing Director.

(ii) The PAC France business is currently administered by PIMS on behalf of PAC and PIA's Managing Director exercises a delegated authority over the branch business. As part of the transfer, the existing arrangement between PAC and PIMS in respect of the business of PAC France will be transferred to PIA, but in substance will otherwise remain unchanged.

(iii) The PAC Malta business is currently administered by PDL with PIA's Managing Director exercising a delegated authority over the business. Following the transfer, these policies will come within the terms of the existing PIA/PIMS outsourcing arrangement. Given the nominal number of policies, there will be no outsourcing agreement in place to cover this business between PIMS and CLPSI, and PIMS will administer the business itself (at that time it will have in place the necessary regulatory authorisations to do so).

(iv) The business previously written by ELAS is currently serviced by Equiniti under an outsourcing agreement between PAC and Equiniti. These policies will be transferred to PIA but PAC will continue to be responsible for the servicing of this business through its agreement with Equiniti, which will not transfer to PIA.

6.12 Exclusions

There are expected to be no exclusions from the transfer of any policyholder assets or liabilities for the groups described in 6.2.1 above.

6.13 Amendment of PAC's Principles and Practices of Financial Management (PPFM) and Prudential's Statement of Unit-Linked Principles and Practices (PSULPP)

PAC's Principles and Practices of Financial Management (PPFM) sets out the principles and practices that Prudential UK & Europe applies in the operation of the with-profits business. It will be amended as appropriate to reflect the transfer (with notices being provided to the relevant policyholders as part of the standard process for updating the PPFM). The amendments required are not material.

The Principles of Financial Management for the ELAS business (and the corresponding ELAS Scheme) will be amended as required to allow the German and Irish policies to be transferred from PAC to PIA. However, no other changes to the ELAS Scheme and Principles of Financial Management are expected given that the ELAS business will be reinsured back to PAC and there will be no change in the management of this business as described in section 6.6.3 above.

Prudential's Statement of Unit-Linked Principles and Practices (PSULPP) sets out the principles and practices that Prudential UK & Europe applies in the operation of all of its unit-linked funds. The PAC France unit-linked business is currently within the scope of the PSULPP. Following the transfer, the PAC France business will continue to be invested in the same unit-linked funds and these will continue to be subject to the PSULPP. The PSULPP will be updated accordingly to reflect this.

The amendments are expected to be made prior to the transfer.

6.14 Amendment of PAC and PIA's Investment Management Agreements (IMAs)

For the PAC France unit-linked business, a fund account is currently in place with Carmignac and Vega to allow access to the corresponding unit-linked funds. PIA will arrange with Carmignac and with Vega for the fund accounts to be transferred to PIA with effect from the Scheme Effective Date.

There are no other investment management agreements in place that would be affected by the Scheme.

6.15 Policyholder communications

Parties to a scheme made pursuant to Part VII of FSMA must comply with notice requirements set out in FSMA (Control of Business Transfers) (Requirements on Applicants) Regulations 2001. These require notice of the proposed transfer to be sent to all policyholders of the companies involved and published in, inter alia, the official gazettes and two national newspapers in the UK and each EEA state of the commitment for any policy included in the transfer.

In relation to the individual mailing requirements, it is proposed that, subject to certain limited and customary exceptions, all PIA policyholders and all PAC policyholders who are proposed to be transferred, as set out in section 6.2.1 above, for whom Prudential has a valid address, will be sent written details of the proposed transfer. This will include information on the options available to the policyholder if they have any concerns about the transfer.

PAC is not proposing to write to its remaining policyholders on the basis that it would be disproportionate to do so for the following reasons:

(i) the financial impact of the Scheme on PAC policyholders is expected to be negligible;

(ii) as a result of the transfer there will be no change to the terms and conditions of the existing PAC policies that are not transferring;

(iii) PAC policyholders will continue to be administered in the same way following the Scheme;

(iv) the cost of mailing the PAC policyholders is expected to be around £3m which would be disproportionate to any benefits; and

(v) there will be press advertising for the Scheme to comply with the advertising requirements.

7. PAC - FINANCIAL IMPACT OF PROPOSED TRANSFER

7.1 The impact of the proposed transfer of PAC's liabilities to PIA has been assessed on the Solvency II balance sheet, with financial impacts assuming the proposed transfer happened on 31 December 2017. The results are as shown in Figures 7.1.

7.2 Solvency II

Figure 7.1 – PAC Solvency II valuation results after the transfer (as at 31 December 2017)

	Pre-transfer		Post-transfer		Impact	
	Total PAC shareholder-backed business (1) £m	**Total PAC With-Profits Fund(2), (3) £m**	**Total PAC shareholder-backed business (1) £m**	**Total PAC With-Profits Fund(2), (3) £m**	**Total PAC shareholder-backed business (1) £m**	**Total PAC With-Profits Fund(2), (3) £m**
Assets	78,556	132,826	78,626	132,826	69	-
Best Estimate Liabilities (BEL)	58,826	115,632	58,894	115,632	69	-
Risk Margin (net of TMTP)	1,366	726	1,367	726	-	-
Other Liabilities	4,554	6,890	4,554	6,890	-	-
Own Funds	**13,810**	**9,578**	**13,810**	**9,578**	**-**	**-**
SCR	7,143	4,775	7,143	4,775	-	-
Surplus	**6,666**	**4,803**	**6,666**	**4,803**	**-**	**-**
Solvency ratio	193%	201%	193%	201%	-	-

Notes:

(1) The results for the PAC shareholder-backed business have been restated to allow for the transaction PAC entered into to transfer a portion of the shareholder-backed non-profit annuity business to Rothesay (as discussed in section 2.1.9 above).

(2) This represents an economic view of the Solvency II balance sheet for the with-profits business. The presentation required by the Solvency II regulations excludes the liability (and associated capital requirements) related to the present value of the future shareholder transfers.

(3) The results shown include the DCPSF assets and liabilities.

7.2.1 In aggregate, the Solvency II surplus as at 31 December 2017 for the total PAC shareholder-backed business and total PAC With-Profits Fund are unchanged by the transfer. This is because the non-profits business is transferred into PIA which remains part of PAC's shareholder-backed business and as discussed in section 6.6.2 and 6.6.3 above, the with-profits business will be reinsured back into the respective PAC with-profits funds.

The £69m increase in assets and BEL for the PAC shareholder-backed business reflects the transfer of with-profits business into PIA and the corresponding reinsurance of the business back into the respective PAC with-profits funds. Project costs associated with the Part VII transfer have already been allowed for in the 31 December 2017 valuation results.

7.2.2 The impact of the transfer on the PIA solvency position is included in section 8.1 below.

7.3 Risk Appetite

7.3.1 The transfer is expected to have no impact on PAC's risk appetite positions.

8. PIA – FINANCIAL IMPACT OF PROPOSED TRANSFER

8.1 Solvency II

8.1.1 The impact of the proposed transfer from PAC to PIA on PIA's Solvency II valuation has been assessed on the Solvency II balance sheet, assuming the proposed transfer happened on 31 December 2017.

Figure 8.1 – PIA Solvency II valuation results before and after the transfer (as at 31 December 2017)(1)

	Before the transfer £m	After the transfer £m
Assets	6,752	6,828
Best Estimate Liabilities	6,401	6,454
Risk Margin	44	52
Other Liabilities	104	109
Own Funds	**203**	**214**
SCR	130	146
Surplus	**74**	**68**
Solvency ratio	157%	147%

Notes:

(1) The results shown do not include the contribution from PIMS for consistency with results presented in PIA. Typically, within PAC (for example in valuation reports for the PAC Board), consolidated results for PIA and PIMS are presented. If results for PIMS were to be included the pre-transfer assets, best estimate liabilities, own funds, surplus and solvency ratio would be £6,756m, £6,404m, £204m, £74m and 157% respectively; the post-transfer assets, other liabilities, best estimate liabilities, surplus and solvency ratio for PIA would be £6,832m, £6,457m, £214m, £68m and 147% respectively.

8.1.2 There is a c.£6m decrease in PIA surplus from the transfer of the PAC Poland non-profit business. This is because the capital requirements and deferred tax liabilities being set up by PIA for the business exceeds the negative liability being transferred.

The other blocks of business transferred into PIA have an immaterial impact on PIA surplus as the assets transferred broadly offset the liability and capital requirements of the business.

8.2 Projected Solvency II balance sheet

8.2.1 The impact of the proposed transfer to PIA has also been assessed by looking at financial projections to consider how the Solvency II surplus position of the company will evolve after the transfer. The financial projections have been produced by PIA using the assumptions in the 2017 PIA ORSA.

8.2.2 Based on the projection results, I am content that PIA is expected to be well capitalised on the date of the transfer. However, the PIA solvency position should be closely monitored and appropriate actions should be taken if the PIA solvency position deteriorates.

9. IMPACT OF THE PROPOSED TRANSFER ON TRANSFERRING PAC POLICYHOLDERS

9.1 Principles of assessment

9.1.1 In assessing the impact of the proposed transfer on PAC policyholders, I have considered its potential impact on:

(i) the security of policyholder benefits, and

(ii) the maintenance of policyholders' reasonable expectations.

9.1.2 In this section, I have considered the impact of the transfer on the policyholders who will be transferred to PIA. These are defined in section 6.2.1 above and referred to as the transferring policyholders.

9.1.3 In section 10 below I have also considered the impact that the transfer will have on all other PAC policyholders, including the long-term insurance policyholders in the NPSF and the With-Profits Fund (WPSF, SAIF and DCSPF), and on PAC's general insurance policyholders. These are referred to as the remaining policyholders.

9.1.4 In considering this transfer, I have had regard to the risk that the final terms of Brexit may result in PAC not being able to legally administer the transferring policies.

9.2 Security of the transferring policyholders' benefits

<u>Financial strength</u>

9.2.1 For non-profit business, the security of the policyholders' contractual benefits is dependent upon the surplus assets available to support the business.

As shown in section 7 above, the PAC shareholder-backed business had c.£6.7bn of surplus capital in excess of the Solvency II capital requirements as at 31 December 2017, with a solvency ratio of 193% prior to the transfer (after allowing for the reinsurance transaction with Rothesay discussed in section 2.1.9 above).

As shown in section 8.1.1 above, as at 31 December 2017 the PIA capital in excess of the Solvency II capital requirements is £74m, with a solvency ratio of 157%, so PIA is well capitalised. Following the transfer, PIA would have a capital surplus of £68m and a solvency ratio of 147% and so remains well capitalised. However, the PIA solvency position should be closely monitored and appropriate actions should be taken if the PIA solvency position deteriorates.

Since both PAC and PIA are expected to be well capitalised, it is reasonable to conclude that there is no material adverse impact to the security of the policyholder benefits for the transferring non-profit business.

In addition, as discussed in section 9.4.4 below, the Swiss Re treaty in relation to the PAC Poland non-profit business will continue to apply with the same proportion of the liabilities being reinsured to Swiss Re.

9.2.2 For with-profits business, the security of the policyholders' contractual benefits is, in the first instance, dependent upon:

(i) the surplus assets in excess of the capital requirements in the associated with-profits fund, and

(ii) the additional support which may be available to the associated with-profits fund from the shareholder fund (including support to the WPSF through the PAC Mis-selling Cost Assurance that was given by Prudential plc in July 1998).

As discussed in section 6.6.2 above, a reinsurance treaty will be implemented between PIA and PAC to reinsure the Polish with profits benefits back to the WPSF. This treaty will be a 100% quota share reinsurance arrangement, whereby PIA shall pay PAC the future regular premiums paid by policyholders in respect of the Polish with profits business and PAC shall pay PIA the claims (including an appropriate share of future profits) and relevant expenses. Given the operation of the reinsurance arrangement, the transferring policyholders will continue to effectively participate in the WPSF on the same terms and with the same level of protection as they had pre-transfer.

To further protect the interests of the policyholders, the circumstances in which the treaty can be terminated are restricted and will, except in limited circumstances, be subject to the agreement of an independent actuary and the With-Profits Committee of PAC (or any replacement or successor committee) that such termination is appropriate.

As set out in section 6.6.3 above, further reinsurance treaties will be implemented between PIA and PAC in respect of the policies transferred from PAC Malta, PAC France and business previously written by ELAS to reinsure the corresponding with-profits business back into the respective PAC with-profits funds.

In addition to the reinsurance arrangements being set up, PAC will grant PIA a 'pari passu' charge on the assets of PAC such that in the event of PAC becoming insolvent, PIA would rank alongside the direct written policies of PAC.

<u>Change in risk profile</u>

9.2.3 The proposed transfer will change the risks to which the transferring policyholders are exposed to.

9.2.4 PAC and PIA are both sensitive to market related risks including equity and credit risk. PIA is less sensitive to interest rate risk and longevity risk compared with PAC. However, PIA is more sensitive to non-market risks including persistency risk and expense risk. Overall both PAC and PIA are well diversified and able to withstand a wide range of market and non-market stresses.

<u>Financial Services Compensation Scheme (FSCS)</u>

9.2.5 The FSCS exists to provide protection to policyholders in the event that a UK insurer is unable to meet its claims to policyholders. Currently all transferring policies qualify for FSCS protection, but it is likely that the transferring policyholders will lose this protection when the business is transferred to PIA. In my view the loss of FSCS protection does not represent a material adverse impact on the security of benefits or on policyholders' reasonable expectations, on the basis that the probability of PIA not being able to pay policyholders' contractual benefits is remote. (PIA is subject to Solvency II requirements and is therefore required to hold regulatory capital requirements to cover a 1-in-200 event over 1 year and then, in addition, through the application of its Risk Appetite Framework, aims to hold a capital buffer of 50% of the capital requirements as a further buffer against adverse experience.)

9.2.6 In addition, the loss of FSCS protection (which as noted above has only limited value) needs to be considered against the risk of an adverse outcome for EU-based policyholders resulting from the eventual outcome of the Brexit negotiations. Whilst it is difficult to put a probability on an adverse outcome, there are plausible Brexit scenarios where the adverse outcome from Brexit were the policyholders to remain in PAC would be more disadvantageous to policyholders than the loss of FSCS protection.

Walk-away option

9.2.7 Further, while as a matter of company law, PAC would not legally be required to support PIA in the event of it not being able to meet its claims, I believe that, given the likely expectations of the regulators, PAC would continue to support PIA in all but the exceptional circumstance where PAC was itself at risk of not being able to meets its claims.

9.3 Reasonable benefit expectations of policyholders

Non-profit

9.3.1 All of PAC's transferring shareholder-backed business is non-profit or unit-linked. In the case of unit-linked business, the benefits are linked to the performance of the funds that the policyholder has invested in. In the case of other non-profit business, payments are guaranteed upon a specified event, e.g. death, illness or maturity. Policyholders' reasonable benefit expectations extend purely to the payment of these contractual benefits and to the operation of their policies in line with contractual terms and implied service standards.

9.3.2 Following the transfer, there will be no change to these contractual benefits and no material change to the servicing arrangements (as discussed in section 9.4.3 below). In addition, as discussed in section 9.2 above, PIA would still be well capitalised following the transfer. It may therefore be concluded that PIA will continue to be able to meet its policyholders' reasonable benefit expectations with a high degree of confidence (that is not materially different from the current position).

With-profits

9.3.3 PAC's with-profits policyholders' reasonable benefit expectations depend primarily on:

(i) the principles and practices that are used to manage the fund, including those in relation to risk appetite, investment, bonus and claims pay-out policies, and

(ii) the capital strength of the fund, which allows the fund to operate in accordance with these principles and practices.

9.3.4 As described in sections 6.6.2 and 6.6.3 above, reinsurance arrangements will be set up between PIA and PAC on terms that ensure that the transferring with-profits policyholders participate in the WPSF on the same terms, and with the same level of protection, as they had pre-transfer. In particular, this means that the requirements under Chapter 20 of the Conduct of Business Sourcebook (COBS) of the FCA

Handbook and the principles set out in the PPFM that have been applied by PAC to the transferring with-profits business will continue to be applied post transfer.

9.4 Other considerations

9.4.1 Continuation of business following Brexit

As set out in section 6.3.2 above, a benefit from the transfer is that it can help to ensure that the transferring policies can continue to run smoothly given that post-Brexit it might not be possible for PAC as a UK insurance company to operate in the same way it has done previously within the EU.

9.4.2 Taxation

It has been confirmed by PAC's tax advisors that the tax position of PAC's transferring policies will not be impacted by the transfer.

9.4.3 Servicing

As set out in section 6.11 above, the servicing arrangements for transferring PAC policyholders (such as policy administration and investment management), and the effective management and governance of the transferring business, will continue to operate in the same, or a sufficiently similar, way following the transfer and there should be no adverse impact on the transferring policyholders.

9.4.4 Reinsurance Arrangements

As discussed in section 6.6.1, the portion of the existing reinsurance arrangement between PAC and Swiss Re in respect of the non-profit protection business and the non-profit riders on the with-profits business of PAC Poland will be transferred to PIA pursuant to the Scheme. The part of the arrangement in respect of the mortality risk on the with-profits business of PAC Poland will not be transferred to PIA, as the risk will remain with PAC due to the with-profits reinsurance arrangement between PIA and PAC. The reinsurance arrangements between each of PAC and PIA with Swiss Re will continue to cover future new business written in Poland in accordance with the existing terms of the current Swiss Re treaty.

The existing treaty between PAC and Swiss Re for PAC Malta business will remain unchanged as the PAC Malta with-profits business will be reinsured back into PAC upon the proposed transfer.

9.4.5 PAC Pension Mis-selling Costs Assurance

An assurance was given in July 1998 that deducting personal pensions mis-selling costs from the PAC inherited estate would not have an adverse effect on the level of bonus paid to policyholders or their reasonable expectations, and that in the unlikely event of this proving not to be the case, the intention is that an appropriate contribution to the long-term insurance fund would be made from shareholders' funds for as long as the situation continued.

As a result of the reinsurance arrangements being set up to reinsure the transferring with-profits business back to the respective with-profits funds (as described in sections 6.6.2 and 6.6.3 above), it is expected that policyholders who were originally covered by the assurance will continue to benefit from it following the transfer. The nature of the assurance will remain unchanged.

9.4.6 Communication with policyholders

Subject to certain limited and customary exceptions, all transferring PAC policyholders for which Prudential has a valid address will receive written details of the proposed transfer, including information on the options available to the policyholder if they have any concerns about the transfer. I consider this approach to be both fair and reasonable.

9.5 Conclusions

I conclude that the security and reasonable benefit expectations of transferring PAC policyholders will not be materially adversely affected by the transfer.

10. IMPACT OF THE PROPOSED TRANSFER ON REMAINING PAC POLICYHOLDERS

10.1 Principles of assessment

10.1.1 In assessing the impact of the proposed transfer on remaining PAC policyholders, I have considered the potential impact of the transaction on:

(i) the security of policyholder benefits, and

(ii) the maintenance of policyholders' reasonable expectations.

10.2 Security of the remaining non-profit policyholders' benefits

10.2.1 Financial Strength

As discussed in section 9.2.1 above, for non-profit business, the security of the policyholders' contractual benefits is dependent upon the surplus assets available to support the business.

As noted in section 7 above, the proposed transfer would have been expected to have no material impact on the surplus of the PAC's shareholder-backed business.

10.2.2 Risk profile

There will be no material change to the risk profile of PAC following the transfer.

10.3 Security of the remaining with-profits funds policyholders' benefits

10.3.1 As discussed in section 9.2.2 above, for with-profits business, the security of the policyholders' contractual benefits is dependent upon the surplus assets of the associated with-profits fund and any additional support which may be available to the associated with-profits fund.

10.3.2 As shown in section 7 above, the proposed transfer would have been expected to have no material impact on the surplus in the PAC With-Profits Fund. As such, there will be no material change in the strength of the fund or the security of policyholders' contractual benefits.

10.3.3 SAIF will not be directly impacted by the proposed transfer. However, SAIF relies on the WPSF's inherited estate for capital support in return for an annual charge, and it therefore has an interest in its financial strength. Furthermore, in the unlikely event of PAC being wound up due to insolvency, the barriers between the sub-funds would break down and all long-term and shareholder fund assets would be applied to meet all of PAC's liabilities in the order of priority specified in insolvency legislation.

The transfer is not expected to have any material impact on the effective financial strength of the WPSF. It may therefore be concluded that the transfer will not have a material impact on the security or reasonable benefit expectations of policyholders in SAIF.

10.4 Reasonable benefit expectations of policyholders

Non-profit

10.4.1 All of PAC's shareholder-backed business is non-profit or unit-linked. In the case of annuities, the policies guarantee policyholders an annual income from the point of purchase (annuities in payment) or the point of vesting (deferred annuities) until death. The income may be fixed, or increase in a specified way, in payment and, for deferred annuities, in the period prior to vesting. In the case of other non-profit business, payments are guaranteed upon a specified event, e.g. death, illness, maturity. In the case of unit-linked business the benefits are linked to the performance of the funds that the policyholder has invested in. Policyholders' reasonable benefit expectations extend purely to the payment of these contractual benefits and to the operation of their policies in line with contractual terms and implied service standards.

10.4.2 Following the transfer, there will be no change to these contractual benefits or to the servicing arrangements (as discussed in section 10.5.5 below). In addition, as discussed in section 10.2 above, the level of PAC's solvency will be materially unchanged following the transfer. It may therefore be concluded that PAC will continue to be able to meet its policyholders' reasonable benefit expectations with a high degree of confidence (that is not materially different from the current position).

With-profits

10.4.3 PAC's with-profits policyholders' reasonable benefit expectations depend primarily on the principles and practices used to manage the fund and the capital strength of the fund.

Neither the management of the WPSF, SAIF or DCPSF, nor the security and reasonable benefit expectations of the WPSF, SAIF or DCPSF policyholders, will be directly affected by the transfer.

10.5 Other considerations

10.5.1 Charges from ELAS asset shares

As set out in section 2.3.2 above, the NPSF bears all the expenses in respect of the business transferred from ELAS in the DCPSF and, in return, receives an annual management charge on the ELAS asset shares. This is expected to remain unchanged following the transfer.

10.5.2 TMTP

As discussed in section 10.2.2 above, the Part VII transfer is not expected to result in a material change in the risk profile of PAC and is therefore not expected to result in an application to recalculate the TMTP.

10.5.3 Other Solvency II considerations

The Part VII transfer is not expected to have any impact on the Solvency II approvals currently in place or on the ORSA.

10.5.4 Taxation

The tax position of PAC's remaining policies will not be impacted by the transfer and so the Part VII transfer is not expected to have any effect on policyholder taxation.

10.5.5 Servicing

The servicing arrangements for remaining PAC policyholders (such as policy administration and investment management), and the effective management and governance of PAC's business, will be unchanged by the transfer.

10.5.6 Capital Support Arrangements

As described in section 2.4.3 above, the WPSF provided initial and ongoing funding to the PAC Poland branch. The accumulated level of funding plus interest is due to be repaid to the WPSF within 12 years by way of charges levied on with-profits policies written by the PAC Poland branch. In the event that the charges received by the WPSF are not sufficient to repay the accumulated funding provided then the PAC shareholder fund would be responsible for the outstanding balance to protect the WPSF inherited estate from loss; this is referred to as the Polish shareholder underpin.

Following the Part VII transfer, the WPSF will continue to provide this funding as part of the reinsurance arrangement described in section 6.6.2 above, and the PAC shareholder fund will continue to provide the underpin to the WPSF to protect it from loss.

10.5.7 PAC Pension Mis-selling Costs Assurance

As described in section 2.2.6, an assurance was given in July 1998 that deducting personal pensions mis-selling costs from the PAC inherited estate would not have an adverse effect on the level of bonus paid to policyholders or their reasonable expectations, and a CSA was implemented between Prudential plc and PAC to support this.

As a result of the reinsurance arrangements being set up to reinsure the transferring with-profits business back to the respective with-profits funds (as described in sections 6.6.2 and 6.6.3 above), it is expected that policyholders who were originally covered by the assurance will continue to benefit from it following the transfer. The nature of the assurance will remain unchanged.

10.5.8 Communication with policyholders

PAC is not proposing to write to its remaining policyholders because it would be disproportionate to be required to do so for the reasons set out in section 6.15 above. On this basis a waiver has been requested.

I agree with the decision to apply for a waiver in this regard.

10.6 Conclusions

I conclude that the security and reasonable benefit expectations of the remaining PAC policyholders will not be materially adversely affected by the transfer.

11. CONCLUSION

11.1 I have reviewed the proposed transfer and concluded that as part of the prudent management of PAC and its subsidiaries it is not inappropriate to transfer PAC's European liabilities, identified in section 6.2.1 above, to PIA.

11.2 I have also reviewed the impact of the proposed transfer on the transferring policyholders of PAC and the remaining policyholders of PAC and am satisfied that:

(a) the security of PAC's transferring policyholders will not be materially adversely affected by the transfer,

(b) the reasonable benefit expectations of PAC's transferring policyholders will not be materially adversely affected by the transfer,

(c) the security of PAC's remaining policyholders (in all sub-funds) will not be materially adversely affected by the transfer,

(d) the reasonable benefit expectations of PAC's remaining policyholders (in all sub-funds) will not be materially adversely affected by the transfer.

Stewart Gracie

29 June 2018