The Equitable Life Assurance Society
The Prudential Assurance Company Limited

Report of the Independent Expert on the terms of a proposed Scheme to transfer the with-profits annuity business of The Equitable Life Assurance Society to The Prudential Assurance Company Limited

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Worldwide

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Section		Page
1	Introduction	1
2	Background information on ELAS	5
3	Background information on PAC	16
4	Summary of the proposals and the Scheme	21
5	Financial position of ELAS before and after implementation of the proposed Scheme	37
6	Financial position of PAC before and after implementation of the proposed Scheme	47
7	Implications for the holders of Transferring Policies	54
8	Implications for the holders of policies remaining in ELAS	74
9	Implications for the existing holders of policies in PAC	78
10	Summary of conclusions	82

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1 Introduction

Background

1.1 The Equitable Life Assurance Society ("ELAS") and The Prudential Assurance Company Limited ("PAC") are making an application to the High Court of Justice in England and Wales (the "Court") for the sanction under Section 111 of the Financial Services and Markets Act 2000 (the "FSMA") of an insurance business transfer scheme for the transfer of the with-profits annuity business of ELAS to PAC (the "Scheme") and for certain further orders under Section 112 of the FSMA. Separate insurance business transfer schemes are also due to take place in Guernsey and Jersey.

1.2 I have been appointed jointly by ELAS and PAC to report pursuant to Section 109 of the FSMA in the capacity as Independent Expert on the terms of the Scheme and on the schemes in Guernsey and Jersey, which are the subject of a supplementary report to this report. The costs of my appointment are to be borne by ELAS and PAC in equal parts.

1.3 My appointment as the Independent Expert has been approved by the Financial Services Authority (the "FSA") which has also approved the form of my report.

1.4 As Independent Expert I have a duty to the Court which overrides any obligation to any person from whom I have received instructions or to any person who has met the costs of my appointment.

Qualifications and experience

1.5 I am a Fellow of the Institute of Actuaries, having qualified as such in 1988 and hold a certificate issued by the Institute of Actuaries to act as a Life Actuary (including with-profits).

1.6 I am a consulting actuary working in the Insurance & Financial Services Practice of Watson Wyatt Limited. I have over 23 years experience in the UK life assurance industry including experience as an actuarial function holder and with-profits actuary. I have also advised a number of clients in connection with insurance business transfers involving with-profits business.

Independence

1.7 I have not undertaken any previous assignments for ELAS or any of its subsidiaries (companies in the "Equitable Life Group") or for PAC, any of its holding companies or any of its or their subsidiaries (companies in the "Prudential Group"). I am not a policyholder or customer of any company in either the Equitable Life Group or the Prudential Group, nor do I have any other financial interest in either Group.

1.8 I was the holder of a with-profits personal pension plan with ELAS which, to remove a potential conflict of interest, I was required to transfer to another pension provider on accepting this appointment. The terms of the transfer were on ELAS's normal terms.

1.9 Other employees of Watson Wyatt Limited (and partners in, and employees of, its predecessor firms) are advising, or have previously provided advice to, companies in the Equitable Life Group and the Prudential Group and to the trustees of the Prudential Staff Pension Scheme. However, I do not believe that any of this advice is of such a nature as to affect my independence in relation to this appointment or to restrict my ability to report on the terms of the Scheme.

The Scheme

1.10 Under the proposed Scheme, the majority of the with-profits annuities of ELAS (the "Transferring Policies") together with certain assets (the "Transferring Assets") and certain liabilities under the Transferring Policies and the Transferring Assets will transfer from ELAS to PAC on the date that the Scheme becomes effective (the "Effective Date"), which is expected to be 11.59pm on 31 December 2007.

1.11 The Scheme also contains provisions covering the financial management of the Transferring Policies by PAC after the Effective Date.

Scope of this report

1.12 This report has been prepared in accordance with the guidance contained in Section 18.2 of the Supervision Manual ("SUP 18.2") of the FSA Handbook of Rules and Guidance (the "FSA Handbook") on the form and content of the scheme report that must accompany an application to the Court to approve an insurance business transfer.

1.13 I have interpreted the primary purpose of this report to be to provide an opinion of the likely effects of the Scheme on policyholders, distinguishing between:

- holders of Transferring Policies;
- policyholders of ELAS whose contracts will not be transferred; and
- policyholders of PAC.

1.14 In so far as I consider them relevant to the above, this report also includes a summary of the terms of the Scheme and background information on the businesses of ELAS and PAC.

1.15 My remit did not extend to considering possible alternative arrangements to those in the proposed Scheme or to the likely effects of the Scheme on new policyholders, that is those whose contracts are entered into after the Effective Date.

Reliances and limitations

1.16 I have been given free access by ELAS and PAC to any documents I have requested to facilitate my review of the Scheme. These documents included:

- The report and accounts of both ELAS and PAC for 2006
- Returns made to the FSA by ELAS and PAC for 2006
- The current versions of the Principles and Practices of Financial Management ("PPFM") issued by both ELAS and PAC in respect of their with-profits business
- A document entitled "A guide to how we manage the with-profits fund" issued by ELAS and dated April 2006
- The agreement between ELAS and PAC entitled "Agreement relating to the transfer of the with-profits annuity business of The Equitable Life Assurance Society to The Prudential Assurance Company Limited" dated 14 March 2007
- The proposed Scheme in final draft form
- A draft of the Circular proposed to be sent to the ELAS policyholders (the "Policyholder Circular")
- Reports prepared by the Actuarial Function Holder and With-Profits Actuary of ELAS on the impact of the proposed transfer on its policyholders, both dated 29 August 2007
- A report prepared by the Actuarial Function Holder of PAC on the proposed transfer, dated 29 August 2007, and a certificate provided by the With-Profits Actuary of PAC indicating his agreement with the content of the PAC Actuarial Function Holder's report insofar as it relates to PAC with-profits policyholders.

1.17 In addition, I have had access to and discussions with the management of ELAS and PAC and their professional advisers to assist me in the completion of this report.

1.18 In carrying out my review of the Scheme and producing this report I have relied without independent verification upon the accuracy and completeness of the data and information provided to me both in written and oral form. Where possible, I have however considered, and am satisfied as to the reasonableness of, the information provided to me based on my knowledge and experience of the UK life assurance industry.

1.19 Both ELAS and PAC have confirmed that the data and information provided to me by them is accurate and complete and that there are no material inaccuracies or omissions in the description of their business given in this report to the best of their knowledge and belief.

1.20 This report has been prepared for use by:

- The Court and the Royal Courts of Guernsey and Jersey
- The FSA and the insurance regulators in Guernsey and Jersey
- The directors of ELAS and PAC

Except with my written consent, this report must not be reproduced, distributed or otherwise communicated in whole or in part to any other party save that copies of this report may be made available for inspection by policyholders of ELAS and PAC and copies may be provided to any person requesting the same in accordance with legal requirements.

1.21 This report must be considered in its entirety as individual sections, if considered in isolation, may be misleading. No summary of this report may be made without my express permission. I have provided a summary of this report for inclusion in the Policyholder Circular.

1.22 This report has been prepared in accordance with the guidance contained in SUP 18.2 of the FSA Handbook to meet the specific purposes of the parties listed in paragraph 1.20 above in relation to the proposed Scheme and must not be relied upon for any other purpose. The report is not intended for use by any third party and no third party should place any reliance on the report in deciding to do or to omit to do anything. For the avoidance of doubt, this report was not specifically intended to, and may not therefore, address the particular needs, concerns or objectives of any individual policyholder. No liability will be accepted for application of this report to a purpose for which it was not intended or for the results of any misunderstanding by any user of any aspect of this report.

1.23 I am available to assist any of the parties listed in paragraph 1.20 above in interpreting this report.

1.24 Nothing in this report should be taken as investment advice.

2 Background information on ELAS

Constitution, structure and membership

2.1 ELAS was established as a mutual life assurance company in 1762 as the Society for Equitable Assurances on Lives and Survivorships. It was registered as an unlimited company with its current name, The Equitable Life Assurance Society, on 18 August 1892.

2.2 ELAS has been granted permissions by the FSA under the terms of the FSMA to effect and carry on long-term insurance business in classes I-IV, VI and VII. The vast majority of ELAS's business has been written in the United Kingdom. A small amount of business has also been written through branches in Guernsey, Germany and Ireland. A single long-term insurance fund is maintained to transact all long-term insurance business.

2.3 ELAS is a mutual company and accordingly has no shareholders. Under the Articles of Association of ELAS, its members essentially comprise persons who have taken out with-profits policies with ELAS which remain in force and continue to participate in the profits of ELAS. However, not all with-profits policyholders are members of ELAS. For example, only a person to whom a with-profits policy was originally issued can be a member in respect of that policy and, where a with-profits policy is held jointly by more than one person, only the first-named person on the policy can be a member in respect of that policy.

2.4 In practice, most ELAS with-profits policyholders who will transfer to PAC under the proposed Scheme are also currently members of ELAS.

2.5 The Articles of Association of ELAS provide that a participating policy (i.e. a with-profits policy) confers the right to participate in the profits of ELAS. All members of ELAS must have effected a participating policy but, for the reasons given in paragraph 2.3 above, the beneficiary of a participating policy need not be a member.

2.6 All members may attend general meetings of ELAS. A member may only take part and vote in general meetings if the "total sum assured" (as defined in the Articles of Association) in respect of the participating policies which confer his or her membership is not less than £1,000. For a with-profits annuity, the sum assured for this purpose is defined as ten times the current guaranteed income amount under the policy excluding bonuses. On a poll, each voting member has a number of votes determined by dividing the total sum assured in relation to that member by £1000 subject to a maximum of ten votes per member.

2.7 Being an unlimited company, the members of ELAS would be liable for its debts if it were to go into an insolvent liquidation. To try to reduce the impact of this potential situation, the policies issued by ELAS state that ELAS's liabilities under its policies to its policyholders cannot exceed its assets. In certain adverse circumstances, it is

possible that policyholders could receive benefits under their policies of less than the amounts that would normally be guaranteed.

Recent history

2.8 On 8 December 2000, following a House of Lords ruling earlier in 2000 that ELAS's approach to guaranteed annuity rates (GARs) on with-profits pension policies was unlawful, ELAS closed to new business other than for increments to existing policies where there is a regulatory or contractual obligation to allow increments and the writing of annuities on the vesting of ELAS pension policies. Other than for a few with-profits annuities effected by overseas policyholders up to 2004 (where there was a contractual obligation to offer a with-profits annuity), all new annuities written on the vesting of ELAS pension policies since 8 December 2000 have been non-profit annuities.

2.9 On 1 March 2001, a sale of the operating assets and economic interest in much of the non-profit business of ELAS to the Halifax Group (now HBOS Group) was completed. Since then, ELAS has continued to operate as an independent company but with administration services provided under contract by HBOS.

2.10 In 2002, following a vote by ELAS members, a compromise scheme was approved by the Court under which most policyholders with GARs gave up their GARs in exchange for an uplift to their guaranteed benefits and policy values. Policies without GARs, and a few minor categories of policies on which GARs were not removed by the compromise scheme, generally received a lower level of uplift to their guaranteed benefits and policy values.

2.11 On 9 February 2007, ELAS completed the transfer, under Part VII of the FSMA, of the bulk of its non-profit pension annuity business, comprising approximately 130,000 policies with liabilities of approximately £4.6 billion, to Canada Life Limited. ELAS has stated that the rationale for this transaction was the removal of most of the risk to ELAS's with-profits policyholders of unexpected future increases in non-profit annuitants' life expectancy. If policyholders live longer than expected then the company has to increase its reserves to fund the continuing pension and, as a mutual, any such increase in reserves would reduce ELAS's free assets, thereby reducing the amount available to distribute to its with-profits policyholders. At the same time, the transfer improved the financial stability of ELAS and reduced its capital requirements.

2.12 On 1 June 2007, ELAS completed the sale of University Life Assurance Society ("ULAS"), which was a wholly owned subsidiary of ELAS, to Reliance Mutual Insurance Society Limited. ELAS has stated that the rationale for this transaction was that it simplifies the business of ELAS and makes it easier to assess strategic options for its policyholders and, if attractive, to implement them.

2.13 On 6 August 2007, £170.9 million of subordinated bonds originally issued by a wholly-owned subsidiary of ELAS in 1997 were redeemed at their principal amount, together with interest accrued to the redemption date.

Nature of ELAS's business

2.14 Prior to its closure to new business in December 2000, ELAS had offered a full range of savings, protection and pension policies, both non-profit (comprising non-linked and unit-linked policies) and with-profits (comprising traditional with-profits and accumulating with-profits).

2.15 Table 2.1 gives a breakdown of ELAS's mathematical reserves between major product types as at 31 December 2006. It also shows the effect of reinsurance.

Table 2.1: ELAS - Mathematical reserves as at 31 December 2006

	Gross of reinsurance (£m)	Reinsurance ceded (£m)	Net of reinsurance (£m)
With-profits annuities			
UK pension annuities	1,447	-	1,447
UK purchase life annuities	32	-	32
Overseas	32	-	32
	1,511	**-**	**1,511**
Other with-profits business			
UK accumulating with-profits pensions	5,981	37	5,944
UK accumulating with-profits life	289	-	289
UK conventional with-profits pensions	65	-	65
UK conventional with-profits life	149	-	149
Overseas	90	-	90
	6,575	**37**	**6,537**
Non-profit annuities			
Non-profit annuities	4,200	3,630	570
Index-linked annuities	724	635	88
	4,924	**4,265**	**658**
Other non-profit business			
Unit-linked	2,607	2,607	0
Non-linked	280	280	0
	2,887	**2,887**	**0**
Total mathematical reserves	**15,897**	**7,190**	**8,707**

Non-profit business

2.16 With the exception of immediate annuities in payment, 100% of the liabilities under ELAS's non-profit policies have been reinsured with Halifax Life Limited ("Halifax Life"), a company in the HBOS Group, since 1 March 2001. Halifax Life also receives all charges on the reinsured business so that effectively the economic interest (risk and reward) has been transferred to Halifax Life. This reflects the transaction referred to in paragraph 2.9.

2.17 Halifax Life also reinsures immediate annuities in payment that have arisen from the vesting of non-profit deferred annuity policies since 1 March 2001. Most of ELAS's remaining non-profit annuities were reinsured to Canada Life Limited as at 1 January 2006 in anticipation of the transfer of this business to Canada Life Limited on 9 February 2007 referred to in paragraph 2.11.

2.18 The only non-profit business now remaining with ELAS which is not reinsured to Halifax Life Limited is the non-profit annuity business that was not transferred to Canada Life Limited.

With-profits business

2.19 ELAS currently retains the majority of the with-profits business that it has written. The only significant reinsurance in relation to with-profits business is in respect of units purchased in the Clerical Medical Investment Group (CMIG) With-Profits fund which is an investment option under certain group pension schemes. 100% of the liability in respect of these units is reinsured with CMIG. The relevant policies participate in the profits of the CMIG With-Profits Fund via this reinsurance and have, in this respect, no other participation rights in the profits of ELAS.

2.20 ELAS has three basic types of with-profits policy:

- accumulating with-profits ("AWP") business (often referred to by ELAS as Recurrent Single Premium business);
- with-profits annuities; and
- other with-profits business.

2.21 As at 31 December 2006, AWP business accounted for approximately 75% by value (as measured by realistic liabilities) of ELAS's with-profits business. With-profits annuities accounted for approximately 23% and other with-profits business for approximately 2%.

Accumulating with-profits ("AWP") policies

2.22 Under AWP policies, each premium, after deduction of charges, secures a guaranteed benefit. The aggregate of these guaranteed benefits is the minimum amount payable on the occurrence of specified events such as retirement or death. On the majority of AWP policies, the value of the guaranteed benefit is increased by a guaranteed investment return (the "GIR"), typically at the rate of 3.5% each year for policies issued before 1 July 1996, and 0% p.a. for policies issued after that date (meaning that the guaranteed benefits do not reduce). The guaranteed benefit is also increased by any reversionary bonuses declared. The guaranteed benefit is reduced by withdrawals.

2.23 Each AWP policy also has a second value, called the "Policy Value". ELAS has used the concept of Policy Value for many years to represent a policy's fair share of the assets of ELAS. The Policy Value is used as the starting point for determining payout levels in relation to with-profits benefits.

2.24 The Policy Value is not a guaranteed amount - it can be reduced as well as increased, and it can be more or less than the value of guaranteed benefits under a policy. Each premium paid, net of explicit charges, adds to the Policy Value and withdrawals reduce the Policy Value. Each year, and sometimes more often, the Board may decide to increase or reduce Policy Values, by a particular rate, or set of rates. This is in contrast to guaranteed benefits which cannot be reduced (in the absence of withdrawals by the policyholder).

2.25 The Policy Value on a given policy may be higher or lower than the guaranteed benefits. The payout on the maturity or death of an AWP policy cannot be less than the guaranteed benefits. However, if an AWP policyholder surrenders his policy before the maturity date or retirement dates permitted by the policy conditions, the payout is based on the Policy Value, less a financial adjustment. The financial adjustment is set with the intention that the payout should be fair to the surrendering policyholder but not reduce the prospects of the continuing policyholders.

With-profits annuities

2.26 Under with-profits annuities, the benefits are stated as an annual income (ie an amount of annuity) rather than a capital sum. Each policy has a "guaranteed income" and a "non-guaranteed income" amount attaching to it (often referred to by ELAS as the Guaranteed Annuity and the Total Annuity). The income received by the policyholder in any policy year is the greater of the guaranteed income and the non-guaranteed income.

2.27 The initial amount of the guaranteed income was determined having regard to an assumed (guaranteed) investment return (the "GIR") and an Anticipated Bonus Rate ("ABR"). The guaranteed income reduces each year by the ABR and is increased by any reversionary bonuses declared. The GIR was typically 3.5% per annum for

policies issued before 1 July 1996 and 0% p.a. for policies issued after that date, The ABR was selected by the policyholder (from an available range) and fixed for each policy at the date the policy was written. The ABR typically varies between 0% and 7.5% per annum depending on the individual policy. Policyholders that selected a higher ABR received a higher initial guaranteed income.

2.28 There are around 250 Low Start Annuity Policies, all of which have a GIR of 3.5% per annum, where the guaranteed income increases each year by 3.5% per annum before the application of any reversionary bonuses declared.

2.29 Each year, and sometimes more often, the ELAS Board may decide to increase or reduce non-guaranteed income amounts, by a particular rate, or set of rates (the rates of "non guaranteed bonus") to reflect investment return net of charges and other factors. The non-guaranteed income reduces each year by the combined effect of the GIR and ABR before being adjusted for the announced rates of non-guaranteed bonus.

2.30 The non-guaranteed income is intended to represent the amount of annuity that can be afforded based on the policy's fair share of the assets of ELAS (the equivalent to the Policy Value for AWP business) ignoring future investment return and charges, and allowing for reductions to payments each year equal to the combined effect of the ABR and the GIR relevant to the policy.

2.31 If the non-guaranteed bonus allocated to a with-profits annuity exceeds the combined effect of the GIR and ABR, the non-guaranteed income increases but if it falls short of the combined effect of the GIR and ABR, the non-guaranteed income reduces. The combined effect of the GIR and ABR is relatively high for many with-profits annuities reflecting the higher interest rate environment and hence higher expectations for investment returns when these policies were effected. These policyholders have been experiencing falling incomes in the current lower interest rate environment.

2.32 For a given asset share, the affordable annuity depends on the assumptions made about the future mortality experience of policyholders. However, when ELAS has changed its assumptions about future mortality experience, its practice has been to deem that the with-profits annuities' fair share of the assets of ELAS changes so as not to affect the level of non-guaranteed income attaching to each with-profits annuity.

2.33 The non-guaranteed income can be reduced as well as increased, and it can be more or less than the guaranteed income under a policy. This is in contrast to guaranteed income which cannot be reduced other than by any applicable ABR.

2.34 Unlike AWP policies and other with-profits policies, holders of with-profit annuity policies cannot surrender their policies or transfer their policies to other companies.

2.35 As at 31 December 2006, ELAS had around 60,000 with-profits annuity policies in-force comprising around 66,100 with-profits annuity benefits with aggregate annuities payable of £179 million per annum. (Certain with-profits annuity policies comprise more than one with-profits annuity benefit. For example, there may be separate benefits if different GIRs or ABRs apply to different portions of a policy.)

2.36 The majority of the business comprises pension policies (compulsory purchase annuities) although, as at 31 December 2006, there were around 3,300 purchase life annuity benefits. Policies are on a single life basis or a joint life basis (such that when either the first or a named life dies, a proportion of the annuity continues to the surviving life). Almost all policies are payable for life, although a few are temporary annuities.

2.37 Over 98% of the with-profits annuities in-force as at 31 December 2006 were written in the UK with the balance written through the branches in Guernsey, Ireland and Germany. Around 900 with-profits annuities have benefits denominated in currencies other than sterling.

2.38 A small number of with-profits annuity policies have guarantees applying to them in addition to the guaranteed income described above in the form of a guaranteed minimum pension ("GMP").

Other with-profits policies

2.39 Other with-profits policies include endowments and whole life policies. Under these policies, an amount of guaranteed benefit is payable at a specified date or over a series of dates, or on the occurrence of a specified event. The guaranteed amount can be increased during the term of the policy through reversionary bonuses. A non-guaranteed final bonus may also be added at exit.

Bonus policy

2.40 ELAS operates a system under which bonuses are declared for each calendar year. However the income level under the annuity is only recalculated at the policy anniversary at which time allowance is made for bonus decisions since the previous policy anniversary.

2.41 Since 2000 all distributions of surplus as bonus have been made in non-guaranteed form, and ELAS has indicated that there is no expectation of any further bonus being awarded in guaranteed form in the foreseeable future. This reflects the fact that for many with-profits annuity policies, guaranteed income exceeds non-guaranteed income. The extent to which this is the case differs between with-profits annuity benefits having a GIR of 3.5% per annum ("3.5% GIR Policies") and those having a GIR of 0% per annum ("0% GIR Policies").

2.42 As at 31 December 2006, non-guaranteed income exceeded guaranteed income for the vast majority of 0% GIR Policies (although this had not been the case one year earlier). For a substantial majority (around 80%) of 3.5% GIR Policies, however, the guaranteed income exceeded the non-guaranteed income as at 31 December 2006. For such policies, the gap between non-guaranteed income and guaranteed income (which varied, typically between 0% to 15% of non-guaranteed income) will only close to the extent that bonuses added to non-guaranteed income exceed 3.5% per annum (or more than this if any bonus is declared in guaranteed form).

2.43 Prior to 2000, when ELAS was declaring reversionary bonus additions to guaranteed income, the reversionary bonus rate was always the same for all with-profit annuities with the same GIR. Policies with a GIR of 3.5% per annum always received a reversionary bonus rate 3.5% per annum lower than that declared for policies with a GIR of 0% per annum, reflecting the fact that the guaranteed income on the former group of policies already reflected an anticipated investment return of 3.5% per annum.

Determination of Policy Values

2.44 ELAS aims to set bonuses and payout levels which are fair across different groups and generations of policyholders. Profits and losses are typically shared across the whole of the with-profits business, not just among the policies concerned. For example, the cost of guarantees is shared across the whole of the with-profits business, and mortality profits and losses from the with-profits annuity policies are shared by the whole of the with-profits business, not just among the with-profits annuity policies.

Distribution of Working Capital

2.45 Reflecting the fact that ELAS is closed to new business and a mutual, ELAS intends that all of its assets, after providing for its contractual liabilities (including those to holders of non-profit policies and other creditors), will be distributed as fairly as possible amongst the existing holders of its with-profits policies over the lifetime of those policies. The timing of the distribution of the excess of these assets over the Policy Values or their equivalent and amounts needed to meet the costs of guarantees and smoothing on with-profits policies (referred to as the "working capital") has regard to the need for ELAS to continue to meet its contractual obligations as they fall due and the need to maintain an appropriate level of capital. The non-guaranteed bonus announced by ELAS for 2006 included an addition of around 1% in respect of a distribution of working capital.

2.46 On occasions in the past, in order to bring aggregate Policy Values more in to line with available assets, it has been necessary to apply adjustments to Policy Values. Adjustments (both positive and negative) made to Policy Values and their equivalents have generally been at the same percentage rate for all policies within a particular

class, although ELAS maintains discretion to vary the rate between different groups and generations of policyholders.

Charges for expenses and taxation

2.47 A deduction is made from all Policy Values and their equivalents for expenses and tax. Following a review in 2006 the Board decided that it would aim to maintain this expense deduction at 1% p.a. An additional expense reserve (determined on a realistic basis) is maintained to fund an anticipated shortfall of charges against expenses in future years as diseconomies of scale begin to affect the business.

2.48 To the extent that profits or losses are made on expenses and taxation (as a result of the expense reserve and 1% per annum charge turning out to be higher or lower than required), these will accrue to the working capital and affect the amount available for distribution to the remaining with-profits policyholders from this source.

2.49 Tax payable in respect of post-1991 UK with-profits annuities that are purchase life annuities is charged to the working capital. The investment income credited to these purchase life annuities in determining their non-guaranteed income is gross of tax, the future tax having been reflected in the original terms offered at the inception of the policy.

Charges for the cost of guarantees

2.50 When the guaranteed income on a with-profits annuity exceeds the non-guaranteed income or the guaranteed benefits on maturity of an AWP policy exceed the Policy Value (or the equivalent for other with-profits policies), there is a cost that has to be met from the working capital.

2.51 In order to have sufficient capital to meet the expected future cost of guarantees and to satisfy regulatory and other capital requirements, ELAS retains a margin each year before making increases to Policy Values and their equivalents. The level of the margin is kept under regular review by the Board before deciding any changes to Policy Values and their equivalents. At the latest regular review, it was estimated that an ongoing margin of about 0.5% each year deducted from the return on the with-profits fund (net of tax, where applicable) would be sufficient to meet the cost of guarantees and provide some additional risk capital.

Deferred Cost Policies

2.52 Following the House of Lords' ruling on guaranteed annuity rate policies in 2000, ELAS reduced Policy Values on non with-profit annuity policies by 5% in order to make allowance for the future costs of guaranteed annuity rates. For with-profit annuity policies issued before 20 July 2000 (referred to in this report at Deferred Cost Policies), a similar reduction in non-guaranteed policy benefits is being phased in over time. Annual reductions in bonus of 1% per annum were applied to non-guaranteed

income on Deferred Cost Policies for 2000 and 2001 and of 0.5% per annum for 2005 and 2006. Further reductions in bonus of 0.5% per annum are planned for 2007, 2008, 2009 and 2010.

Investment policy

2.53 ELAS currently operates a conservative investment policy as a result of its solvency position and its need for liquidity. ELAS accordingly invests mainly in fixed interest securities (both gilts and corporate bonds) and is unlikely to be able to alter this policy unless its financial strength increases significantly.

2.54 This strategy is helpful in reducing risk, and in helping to maintain solvency. It shields with-profits policyholders from the worst effects of falling stock markets, but also limits the returns that will be achieved in rising stock markets.

2.55 The mix of assets backing with-profits policies in ELAS as at 31 December 2006 was as follows:

Table 2.2: ELAS - With-profits asset mix

Equities	3%
Property	12%
Fixed interest	78%
Other (mainly cash)	7%

2.56 Prior to 2001, the proportion of equity and property assets backing with-profits policies in ELAS (the equity backing ratio or "EBR") was considerably higher than it is now. Table 2.3 shows the EBR for each year end since 1987, the first year in which with-profits annuity polices were sold by ELAS. The vast majority of the with-profits annuity polices in-force were written prior to December 2000.

Table 2.3: ELAS - Year end EBRs

Year end	EBR	Year end	EBR
1987	66%	1997	70%
1988	70%	1998	68%
1989	78%	1999	73%
1990	72%	2000	67%
1991	71%	2001	42%
1992	63%	2002	19%
1993	63%	2003	18%
1994	69%	2004	19%
1995	67%	2005	19%
1996	69%	2006	15%

2.57 I understand that, subject to solvency considerations, ELAS intends to increase its EBR to a target of around 20% in the relatively short term and possibly higher than this in the medium to longer term.

Smoothing

2.58 ELAS has a preference that changes in levels of bonuses should be gradual. However, in adverse scenarios, especially when investment returns are poor, there is limited scope for smoothing of bonuses because smoothing considerations are over-ridden by ELAS's need to be able to meet its contractual obligations to policyholders and other creditors and any capital requirements.

3 Background information on PAC

Constitution and structure

3.1 PAC is a proprietary insurance company and a wholly owned subsidiary of Prudential plc. PAC was first established in 1848 as The Prudential Mutual Assurance Investment and Loan Association. It changed its name to The Prudential Assurance Company in 1866 and became a limited liability company in 1881. It is governed under a private Act, namely The Prudential Assurance Company Act 1875 as amended by The Prudential Assurance Company Act Amendment Act 1876.

3.2 PAC is a composite insurance company having both life and non-life insurance business. Since January 2002, PAC has no longer written new non-life insurance business. Consequently PAC's retained non-life insurance liabilities relate only to the run off of closed lines of business.

3.3 PAC has been granted permissions by the FSA under the terms of the FSMA to effect and carry on long-term insurance business in classes I-IV, VI and VII and short-term insurance business in classes 1-18 . Long-term insurance business has been written through both the Ordinary Branch and the Industrial Branch. The Industrial Branch was closed to new business on 1 January 1995.

3.4 The majority of PAC's Ordinary Branch business, and all of its Industrial Branch business, has been issued in the UK. A small amount of business has been issued in the Channel Islands and the Isle of Man. The remaining business was issued from branches in France and Hong Kong and from a branch in Malta which was closed to new business in 1981.

3.5 PAC's long-term insurance business consists of life and annuity, pensions, permanent health, and linked long-term business, which is carried on in the Ordinary Branch, and life business which is held in the Industrial Branch. The company's long-term business includes conventional with-profits, accumulating with-profits, non-linked non-profit and linked business.

Fund structure

3.6 As is required by law, the long-term insurance business of PAC is maintained in a fund (the "long-term insurance fund") separate from its other than long-term insurance business. The retained liabilities in respect of PAC's non-life business are provided for outside of the long-term insurance fund (in its "shareholders' fund").

3.7 PAC's Articles of Association provide for the directors to identify the profits arising on blocks of business and, within certain constraints, to attribute those profits between policyholders and shareholders.

3.8 Having regard to its Articles of Association, PAC has divided its long-term insurance fund into the following sub-funds:

- the Defined Charge Participating Sub-Fund ("DCPSF");
- the Non-Profit Sub-Fund ("NPSF");
- the Scottish Amicable Insurance Fund ("SAIF"); and
- the With-Profits Sub-Fund ("WPSF")

3.9 A brief description of each of these sub-funds is given in the paragraphs below.

Defined Charge Participating Sub-Fund (DCPSF)

3.10 The DCPSF contains the investment element of Defined Charge Participating business. This business comprises business reinsured into PAC from Prudential International Assurance plc and other companies and business written through PAC's French branch between 2001 and 2003.

3.11 Defined Charge Participating business is with-profits business. The policies themselves are allocated to the NPSF but the investment element of each premium paid (i.e. the gross premium less explicit charges) is allocated to the DCPSF where it accumulates with investment return. The premium charges, together with annual management charges deducted from the assets of the DCPSF, are allocated to the NPSF, which bears all expenses in relation to this business. Hence all profits (and losses) arising from the excess (or shortfall) of charges over expenses accrue to the NPSF for the benefit of shareholders.

3.12 A bonus smoothing account for the Defined Charge Participating business is maintained in the inherited estate of the WPSF (see paragraph 3.26). When claim payments are made on a Defined Charge Participating policy, the bonus smoothing account is credited or debited with any difference between the amount of the claim payment and the assets attributable to the relevant policy (its "asset share") in the DCPSF. It is intended that in the long-term the aggregate transfers to and from the bonus smoothing account should tend to zero so that no net profit or loss arises in the WPSF.

3.13 The only profit arising in the DCPSF is from investment performance and this is entirely attributable to DCPSF policyholders.

3.14 Capital support for certain business in the DCPSF is provided by the PAC inherited estate within the WPSF. The WPSF receives an annual charge for providing this support, which is funded by shareholders from the NPSF.

Non-Profit Sub-Fund (NPSF)

3.15 As noted above, the NPSF contains the Defined Charge Participating business except for its investment element which is allocated to the DCPSF. Otherwise, the NPSF contains only non-profit business (including unit-linked business).

3.16 All profits arising in the NPSF are attributable to shareholders. Shareholders also finance all expenses and valuation strains associated with the writing of new business in the NPSF.

3.17 The NPSF pays a charge to the PAC inherited estate within the WPSF for the use of economic capital in respect of the DCPSF.

Scottish Amicable Insurance Fund (SAIF)

3.18 The SAIF contains the bulk of the business originally written by Scottish Amicable Life Assurance Society (SALAS) and acquired by PAC in 1997. The business is governed by the scheme that transferred SALAS into PAC.

3.19 The business in the SAIF consists of all the ex SALAS pensions (both with-profits and non-profit), ex SALAS conventional with-profits life business and the investment element of ex SALAS unitised with-profits life business.

3.20 The balance of the ex SALAS business (non-profit and unit-linked life business and the unitised with-profits life business other than the investment element) is allocated to the Scottish Amicable Account (the "SAA"), which forms part of the WPSF.

3.21 The SAIF Fund is operated as a mutual fund with all profits being distributed to the ex SALAS with-profits policyholders including the holders of the ex SALAS unitised with-profits life policies allocated to the SAA (Note: the investment element of those policies is allocated to the SAIF). The SAIF is closed to new business apart from contractual increments. There are surplus assets (an "inherited estate") in the SAIF, which will be distributed as an addition to the benefits payable on with-profits policies in the SAIF.

3.22 The SAIF is provided with financial support from the WPSF in return for an annual charge. In setting investment and bonus policy in the SAIF, a part of the WPSF (the Scottish Amicable Capital Fund or "SACF") is treated as if it were part of the free assets of the SAIF. The SACF, which will run down over time and cannot exceed 15% of the with-profits funds in the SAIF, does not however form part of the inherited estate of the SAIF and is not intended to be distributed to SAIF policyholders, although, in extreme circumstances, it could be needed to meet the cost of guarantees on policies in the SAIF and it would be used to fund any final deficit in the smoothing account for SAIF with-profits policies.

With-Profits Sub-Fund (WPSF)

3.23 The WPSF consists mainly of with-profits business written by PAC through both its Ordinary Branch (including the branches in Hong Kong and Malta) and its Industrial Branch and with-profits business transferred in 2002 into PAC from Scottish Amicable Life plc and business reassured from Prudential (AN) Ltd.

3.24 The WPSF also contains a small amount of non-profit business (including unit-linked business) comprising business written by PAC that has not been allocated to the NPSF and the ex SALAS business allocated to the SAA (see paragraph 3.20).

3.25 Profit arising in the WPSF, including profit arising on the non-profit business in the WPSF, is divided between shareholders and WPSF with-profits policyholders (other than the ex SALAS with-profits policyholders who share in the profits of the SAIF) in accordance with PAC's Articles of Association. These permit up to 5% of divisible profit to be transferred to a common contingency fund before it is divided between policyholders and shareholders. At least 90% of the divisible profit must be attributed to with-profits policyholders with the balance attributable to shareholders. For virtually all business in the WPSF, the current policyholder proportion is 90%.

3.26 The WPSF contains substantial assets in excess of those PAC expects to pay out to meet its obligations to existing policyholders (the "inherited estate"). The inherited estate is capital of the Fund and contributes significantly to the ability of PAC to provide the benefits associated with smoothing of with-profits benefits and guarantees, and to invest a high proportion of the fund's assets in equity type investments (e.g. equity shares and property) when it considers this to be appropriate.

3.27 Prudential Annuities Limited (PAL), a long-term insurance company that has written mainly non-profit and index-linked annuities and that is effectively closed to new business, is an asset of the WPSF.

Proposed reattribution of the inherited estate

3.28 Prudential announced on 15 March 2007 that it is exploring the possibility of a reattribution of the inherited estate in the WPSF. Prudential believes that it would be beneficial if there was greater clarity as to the status of the inherited estate. However, Prudential has stated that reattribution will only proceed if this is in the interests of both policyholders and shareholders. Such a reattribution will need to follow processes set out in the FSA Handbook and will have to have regard to the legal rights of those parties affected.

Investment policy for the WPSF

3.29 PAC's investment strategy for with-profits business in the WPSF is to seek to secure the highest total return whilst maintaining an acceptable overall risk level for the fund. Reflecting this strategy, the distribution of assets backing the with-profits business is currently based primarily on equity and property assets. Asset allocations are however kept under review and could change in the future.

3.30 Table 3.1 shows the mix of those assets in the PAC WPSF attributable to most of its UK with-profits business (excluding SAIF) at 31 December 2006. It can be seen that the aggregate allocation to equities and property was 68%.

Table 3.1: PAC WPSF - With-profits asset mix

Equities	53%
Property	15%
Fixed interest	25%
Other (mainly cash)	7%

4 Summary of the proposals and the Scheme

PART - A - INTRODUCTION

4.1 It is intended that, under the terms of the Scheme, with the exception of 16 policies issued under German law before 1 July 1994, the with-profit annuity policies of ELAS (the "Transferring Policies") together with assets attributable to those with-profits annuities (the "WPA Allocated Amount") will transfer from ELAS to PAC at 11.59pm GMT on 31 December 2007 or such other time and date that ELAS and PAC may agree (the "Effective Date").

4.2 The liabilities under the Transferring Policies, any liabilities under the transferring assets and the rights, benefits and powers of ELAS under the Transferring Policies will also transfer from ELAS to PAC, save for any liabilities arising from acts or omissions occurring on or before the Effective Date (including, for example, mis-selling liabilities or liabilities arising from breaches of policy conditions or regulatory requirements), which will remain with ELAS.

4.3 The Transferring Policies will be allocated to the DCPSF of PAC. However certain liabilities (the "Guarantee Liabilities") and certain contingent liabilities and assets (the "Mortality Obligations and Rights") in respect of the Transferring Policies will be allocated to the WPSF of PAC. The Guarantee Liabilities and the Mortality Obligations and Rights are described in paragraphs 4.19 and paragraphs 4.32 to 4.36 respectively.

4.4 Reflecting this allocation of liabilities, a part of the WPA Allocated Amount (the "Up-front Guarantee Charge" and the "Mortality Premium") will be allocated to the WPSF of PAC, with the balance of the WPA Allocated Amount allocated to the DCPSF of PAC.

4.5 The method of determination of the WPA Allocated Amount, the Up-front Guarantee Charge and the Mortality Premium is described in Part C of this Section 4.

4.6 The amount of assets transferred from ELAS to PAC will be determined as at the Effective Date. The assets transferred on the Effective Date will however be based on estimates and the Scheme provides for adjustments to be made to the amounts transferred at a later date once the amounts can be calculated accurately. Similarly, the extent of a proposed adjustment to the non-guaranteed income and/or asset shares of the Transferring Policies will not be known on the Effective Date and this adjustment will not occur in practice until a date some months after the Effective Date. In describing the Scheme in this section of my report, other than in the paragraphs where I describe the timing of the asset transfers (see paragraphs 4.53 to 4.55) and the adjustment (see paragraphs 4.56 to 4.59), I have ignored the precise timing of the asset transfers and adjustment and assumed that both occur immediately on the Effective Date.

PART B - FINANCIAL MANAGEMENT OF THE TRANSFERRING POLICIES

Asset Shares

4.7 The Scheme requires that as at the Effective Date, individual asset shares are established for the Transferring Policies and that the aggregate asset shares of the Transferring Policies (the "Transferring Policies Asset Shares") be maintained separately from the asset shares of all other policies of PAC. Income is to be paid to holders of the Transferring Policies at a level calculated to exhaust the Transferring Policies Asset Shares over the lifetime of the Transferring Policies, allowing for PAC's expectations of future mortality.

4.8 The initial amount of the Transferring Policies Asset Shares (the "Aggregate Initial Asset Shares") will equal that part of the WPA Allocated Amount allocated to the DCPSF.

4.9 With effect from the Effective Date, the Transferring Policies Asset Shares:

a. will be credited with the achieved returns (net of applicable tax) on the assets backing the Transferring Policies Asset Shares (see paragraphs 4.11 to 4.13);

b. will be debited with amounts in respect of payments made to holders of Transferring Policies (see paragraph 4.17);

c. may be debited with the following charges:

- a charge of 1% per annum for expenses (to be credited to the NPSF of PAC); and
- a charge (a "guarantee charge") of up to 0.5% per annum for the expected cost of guarantees (to be credited to the WPSF of PAC); and

d. if applicable, will be credited or debited with Mortality Transfer Amounts (see paragraphs 4.32 to 4.36).

4.10 No charges may be made on the asset shares of the Transferring Policies other than those referred to in paragraph 4.9 above and the asset shares of the Transferring Policies shall have no exposure to, and shall incur no adjustment for, profits and losses arising from PAC's other policies, experience or business activities. The asset shares of Transferring Policies may however be adjusted if PAC suffers a loss in connection with the transfer under the Scheme in respect of which PAC has a claim against ELAS and, in the opinion of PAC's With-Profits Committee, it is proper for all or part of such loss to be absorbed by the Transferring Policies because they would otherwise retain an improper benefit as a result of the circumstances which gave rise to the loss.

Investment return to be credited to the Transferring Policies Asset Shares

4.11 The asset mix backing the asset shares of the Transferring Policies will be identical to the asset mix backing the greatest number of PAC's with-profits policies unless, in the opinion of the PAC With-Profits Committee, that pool of assets would be unfair to the holders of Transferring Policies, in which case a pool of assets with an asset mix which the PAC With-Profits Committee considers to be most fair to the Transferring Policies shall be used.

4.12 The investment return credited to the asset shares of the Transferring Policies (before deduction of charges and adjustments for tax but net of unrecoverable tax) shall be the same as the rate of investment return (net of unrecoverable tax) actually earned on the asset pool referred to in the previous paragraph. In determining the gross rate of investment return (net of unrecoverable tax), PAC may not treat the Transferring Policies less favourably than it treats other policies for which the crediting of investment return is determined by the investment return of the asset pool referred to in the previous paragraph and will not make adjustments for miscellaneous profits or losses or on account of smoothing.

4.13 The investment return credited to the asset share of a Transferring Policy may be adjusted for any tax liability or credit of PAC arising out of or in consequence of that Transferring Policy in accordance with applicable tax legislation which is properly allocable to such Transferring Policy. While such tax might apply to only certain Transferring Policies (for example, purchase life annuities), except as required for Deferred Cost Policies (see paragraph 4.27), PAC will not apply different rates of non-guaranteed bonus to different Transferring Policies.

Review of guarantee charges

4.14 Any review by PAC of the on-going guarantee charges which are applied to any of PAC's with-profits policies will also include, on a consistent basis, a review of the on-going guarantee charges applied to the Transferring Policies. A review of the on-going guarantee charges on Transferring Policies must also be carried out if the target proportion of equity-type investments backing the Transferring Policies is reduced or increased by a material amount (defined in the Scheme as a reduction or increase to a percentage below or above an integral multiple of 5).

4.15 PAC will carry out any such review of guarantee charges and make recommendations to the PAC With-Profits Committee, which will then review the recommendations and consider whether any change in the on-going guarantee charge should be implemented. The maximum on-going guarantee charge at any time will be 0.5% per annum.

4.16 Any reduction or subsequent increase in the on-going guarantee charges on with-profits policies in PAC will be applied consistently between Transferring Policies and

other with-profits policies of PAC, and will take into account the Up-front Guarantee Charge in respect of the Transferring Policies.

Allocation of the liability for annuity payments on Transferring Policies

4.17 In each calendar year, the amount charged to the DCPSF and debited from the Transferring Policies Asset Shares in respect of annuity payments made on Transferring Policies shall be the amount of annuity payments that would have been payable on the Transferring Policies if:

- actual mortality in that calendar year had been in line with the mortality assumptions made by PAC;
- any guaranteed income amounts in excess of non-guaranteed income amounts had been disregarded; and
- smoothing (see paragraphs 4.28 to 4.31) had not applied.

4.18 To the extent that actual annuity payments made on Transferring Policies in any calendar year are less than or more than the amount debited from the Transferring Policy Asset Shares, the difference will accrue to the WPSF of PAC.

4.19 The obligation of the WPSF to meet the cost of payments of guaranteed income in excess of non-guaranteed income on Transferring Policies is referred to in this report as the Guarantee Liabilities.

Income payable to holders of Transferring Policies

4.20 On the Effective Date, PAC will create a new bonus series (the "Transferring Policy Bonus Series") for the Transferring Policies. All Transferring Policies, and no other policies of PAC, will be allocated to the Transferring Policy Bonus Series.

4.21 Until a new bonus rate is declared by PAC, any interim bonus rate applicable to a Transferring Policy immediately prior to the Effective Date will continue to apply.

4.22 The income payable to the holder of a Transferring Policy will be determined as the greater of:

- the guaranteed income in respect of that Policy; and
- the non-guaranteed income in respect of that Policy after the application of smoothing.

4.23 Immediately following the Effective Date, each Transferring Policy shall have the same level of guaranteed income and the same level of non-guaranteed income as it had immediately prior to the Effective Date.

Guaranteed income

4.24 After the Effective Date, the level of guaranteed income on a Transferring Policy will, in accordance with terms of the policy, be amended at each policy anniversary reflecting the level of ABR applicable to the Policy and any guaranteed bonuses declared by PAC.

Non-guaranteed income

4.25 After the Effective Date, the level of non-guaranteed income on a Transferring Policy will be amended at each policy anniversary reflecting the combined effect of the ABR and the GIR applicable to the policy and the levels of non-guaranteed bonuses and interim bonuses announced by PAC.

4.26 In determining non-guaranteed bonus rates and interim bonus rates, PAC must target levels of non-guaranteed income on Transferring Policies, before the application of smoothing, which meet the requirement of the Scheme (noted in paragraph 4.7) for income to be paid to holders of the Transferring Policies at a level calculated to exhaust the Transferring Policies Asset Shares over the lifetime of the Transferring Policies allowing for PAC's expectations of future mortality.

Deferred Cost Policies

4.27 In determining bonus rates on Deferred Cost Policies (see paragraph 2.52), the planned deductions of 0.5% per annum from non-guaranteed bonus rates declared for 2008, 2009 and 2010 will continue to apply as previously intended.

Smoothing

4.28 Smoothing must be applied to the non-guaranteed income in accordance with the principles set out in paragraphs 4.30 and 4.31. To the extent that smoothing results in a payment of income under a Transferring Policy which is less than or more than the payment that would have been made in the absence of smoothing, the difference is to be credited or debited to the Transferring Policies Smoothing Account (the "Smoothing Account"). The Smoothing Account will be established in the WPSF of PAC at the Effective Date with an initial value of zero.

4.29 The Smoothing Account will be credited (or if it is negative, debited) with the same rate of investment return and debited (or if it is negative, credited) with the same charges as are applied to the Transferring Policies Asset Shares.

4.30 In normal circumstances, the Principles of Financial Management set out in the Scheme (the "PFM") require that smoothing will operate to ensure that:

a. changes in bonus rates are gradual, rather than erratic;

b. the Smoothing Account is managed with the aim that it should always tend to zero, subject to the need for short-term smoothing;

c. in any year, the amount of non-guaranteed income shall:

- not fall by more than 100% x {1-(1/[(1+ABR)*(1+GIR)])}; and
- not rise by more than 100% x {(1+Smoothing Cap)/[(1+ABR)*(1+GIR)]-1}

where the Smoothing Cap will initially be 11% but can be altered by PAC with the approval of the PAC With-Profits Committee; and

d. for Transferring Policies that are Low Start Annuities, the amount of non-guaranteed income shall:

- not fall; and
- not rise in any year by a percentage greater than the Smoothing Cap.

The limits in sub-paragraphs (c) and (d) above are equivalent to restricting the investment return net of charges, after smoothing, applied in any one year in determining the amount of non-guaranteed income to no less than 0% and no more than the Smoothing Cap.

4.31 In certain circumstances, for example following a significant fall or rise in market values (either sudden or over a period of years), the PFM permit PAC to vary the smoothing limits referred to in paragraph 4.30 (c) and (d) above to protect the overall interests of all PAC policyholders. When determining whether any such changes should be made, PAC must apply the same principles as it would for other with-profits business, as stated in PAC's Principles and Practices of Financial Management ("PPFM"), taking account the balance of the Smoothing Account.

Impact of changes in expected mortality

4.32 Under the proposed Scheme, there is a cap and floor on the impact that changes in PAC's view of future mortality in respect of the holders of Transferring Policies can have on the level of non-guaranteed income on Transferring Policies.

4.33 Broadly, if the impact of a change in mortality assumptions is greater than the impact of a 0.5% per annum compound reduction or increase in the annual amount of non-guaranteed income compared to the position based on mortality assumptions specified in the Scheme, there will be a transfer (the "Mortality Transfer Amount") made from the WPSF to the DCPSF, or from the DCPSF to the WPSF, so as broadly to limit that impact to a reduction or increase of 0.5% per annum compound in the annual amount of non-guaranteed income.

4.34 More precisely, the calculations carried out to determine the size of any Mortality Transfer Amount when PAC changes its view on the future mortality to be assumed in the management of the Transferring Policies are as follows:

- PAC will first calculate the present value of the projected future non-guaranteed income payments on the Transferring Policies allowing for reductions to payments from the combined effect of the ABR and the GIR relevant to each policy (referred to below as the "Aggregate Policy Value") on assumptions specified in the Scheme (the "Core Reserving Basis").
- PAC will then determine the annual deduction from, or addition to, the non-guaranteed income (the "Mortality Impact") that would give rise to the same Aggregate Policy Value using a basis equivalent to the Core Reserving Basis defined in the Scheme but with the mortality assumptions in the Core Reserving Basis replaced by the new mortality assumptions (the "New Mortality Basis").
- If the Mortality Impact is outside the range +/- 0.5% per annum, there shall be a transfer (the Mortality Transfer Amount) either from the WPSF to the DCPSF, or from the DCPSF to the WPSF, equal to the difference between the Aggregate Policy Value (calculated on the New Mortality Basis) allowing for the full Mortality Impact and a Mortality Impact subject to a cap or floor of +/- 0.5% per annum.

4.35 Whenever any further change is made to the mortality basis used in the determination of non-guaranteed income amounts on the Transferring Policies the Mortality Impact shall be recalculated as if this had been the first change in mortality basis and to the extent that the corresponding Mortality Transfer Amount is different to the Mortality Transfer Amount that would have resulted at this time had the previous new mortality basis been the first change in mortality basis and applied from this time, there shall be a further Mortality Transfer Amount paid to the WPSF from the DCPSF or from the WPSF to the DCPSF as appropriate.

4.36 The obligations and rights of the WPSF in respect of potential Mortality Transfer Amounts (either to make payments to the DCPSF or receive payments from the DCPSF) are referred to elsewhere in this report as the Mortality Obligations and Rights.

PART C - DETERMINATION OF ASSET ALLOCATIONS

4.37 As noted in Part A of this Section 4, the assets attributable to the Transferring Policies (the WPA Allocated Amount), which are to transferred from ELAS to PAC, will be split between:

- the Up-front Guarantee Charge, which will be allocated to the WPSF of PAC;
- the Mortality Premium, which will also be allocated to the WPSF of PAC; and

- the Aggregate Initial Asset Shares, which will be allocated to the DCPSF of PAC.

4.38 This Part of Section 4 explains the method of determination of the WPA Allocated Amount, the Up-front Guarantee Charge and the Mortality Premium. The Aggregate Initial Asset Shares represent the balance of the WPA Allocated Amount after deducting the Up-front Guarantee Charge and the Mortality Premium.

Determination of the WPA Allocated Amount

4.39 The WPA Allocated Amount will be determined as at the Effective Date by ELAS (using methodologies consistent with those used in the production of figures in its annual returns to the FSA) as the sum of:

- the with-profits benefit reserve of the Transferring Policies (essentially the aggregate of the amounts described in paragraph 2.30 for with-profits annuities as being the equivalent to the Policy Values for ELAS's AWP business);
- the excess of the future cost of guarantees over the value of the planned future deductions from the with-profits benefit reserve for the cost of guarantees; and
- a share of the working capital of ELAS determined by applying the proportion of the with-profits benefit reserve for all with-profits policies of ELAS represented by the with-profits benefit reserve of the Transferring Policies to the total working capital of ELAS and then making potential adjustments:
  - **a.** to allow for the fair allocation of the costs of the Scheme and related transactions;
  - **b.** to reflect the removal from the remaining policies in ELAS of exposure to mortality risk arising from the Transferring Policies;
  - **c.** to reflect the removal from the remaining policies in ELAS of exposure to tax due on future investment returns attributable to Transferring Policies which are purchase life annuities;
  - **d.** to compensate the remaining with-profits policyholders in ELAS for diseconomies of scale; and
  - **e.** any other adjustment deemed appropriate by ELAS after advice from the With-Profits Actuary.

4.40 Unless ELAS agrees otherwise, ELAS's calculation of the WPA Allocated Amount shall be final and shall not be open to challenge by PAC.

Determination of the Up-front Guarantee Charge

4.41 The Up-front Guarantee Charge represents an amount to cover the expected cost of meeting all the guarantees under the Transferring Policies throughout their remaining projected lifetime, after deduction of the value of future on-going charges for those guarantees at the rate of 0.5% per annum of asset share.

4.42 The Up-front Guarantee Charge will be determined, as at the Effective Date, as:

- the aggregate of the Intrinsic Value of Guarantees (see paragraph 4.43 and 4.44) and the Time Value of Guarantees (see paragraphs 4.45 to 4.47) less the Calibration Amount (see paragraph 4.48)

minus

- the value of the Planned Charges for Guarantees (see paragraphs 4.49 and 4.51).

Intrinsic Value of guarantees

4.43 The Intrinsic Value of Guarantees will be determined as the present value of all future Guarantee Liabilities to be met by the WPSF of PAC based on a projection of the guaranteed income and non-guaranteed income on the Transferring Policies using assumptions, including assumptions regarding future mortality, specified in the Scheme as the Core Reserving Basis. This calculation will be based on a deterministic projection (i.e. ignoring stochastic variation) assuming that the assets backing the Transferring Policies earn a risk free rate (based on the risk free yield curve as defined in the Stochastic Reserving Basis) and all future cashflows are discounted to a present value using an equivalent risk free rate.

4.44 I understand that ELAS and PAC independently calculated the Intrinsic Value of Guarantees based on data as at 31 December 2006 using their own actuarial models and arrived at the same value (£58,300,000). As at the Effective Date, as is the case for the calculation of the other elements of the Up-front Guarantee Charge below, the calculation will be performed by ELAS, subject to validation by PAC and reference to an independent expert in the event that the parties do not agree.

Time Value of Guarantees

4.45 An unadjusted Time Value of Guarantees will be determined as the present value of all future Guarantee Liabilities to be met by the WPSF over and above that reflected in the Intrinsic Value of Guarantees when allowing for stochastic variation (i.e. a range of different scenarios around the "average" scenario assumed in the deterministic projection used to calculate the Intrinsic Value of Guarantees). This additional cost arises because in adverse scenarios the cost of guarantees always increases but in benign scenarios there is not always an offsetting reduction in the cost of guarantees (because the cost cannot reduce below zero).

4.46 The calculation of the unadjusted Time value of Guarantees will be performed using the ELAS actuarial model and assumptions specified in the Scheme as the Stochastic Reserving Basis. For the purpose of this calculation:

- the proportion of assets backing the asset shares assumed to be invested in equities, real property and other investments having similar characteristics (the "equity backing ratio") will be the target equity backing ratio that will apply to the assets backing the asset shares of the Transferring Policies immediately following the Effective Date;
- the risk free rate of investment return will be taken to be the yield curve for "gilts" (i.e. British Government securities); and
- the economic scenarios used in the calculation will be chosen to be "market consistent" (i.e. such that if the scenarios were used to determine the price of certain tradable derivatives, they should give a price equivalent to the observable market price).

4.47 The Time Value of Guarantees will be determined by multiplying the unadjusted Time Value of Guarantees determined by ELAS by £70,700,000 and dividing by £62,800,000. I understand that the reason for this adjustment is that when ELAS and PAC independently calculated the Time Value of Guarantees as at 31 December 2006, they arrived at different answers. The main reason for this is likely to be the fact that the two parties used different models to generate the range of economic scenarios considered. However, it is possible that there will have also been other slight differences in methodologies underlying the actuarial models used. The Time Value of Guarantees determined by ELAS as at 31 December 2006 was £62,800,000 whereas the value determined by PAC was £78,500,000. Following discussion between the parties they agreed to use a compromise figure for the purpose of the Scheme, as at 31 December 2006, of £70,700,000. Consistent with this, when the Time Value of Guarantees is calculated as at the Effective Date by ELAS using the same actuarial model and economic scenario generator that they used to produce their 31 December 2006 figure, the value they determine will be grossed up by multiplying by £70,700,000 and dividing by £62,800,000.

Calibration Amount

4.48 The Calibration Amount, which is an amount to be deducted from the aggregate of the Intrinsic Cost of Guarantees and Time Value of Guarantees (the "Total Cost of Guarantees") determined as above, will be determined by multiplying the unadjusted Total Cost of Guarantees by £5,100,000 and dividing by £121,100,000 million. I understand that this adjustment is intended to represent the reduction in Total Cost of Guarantees that would arise from increasing the assumption made for the risk free rate of investment return from an assumption based on gilts to an assumption based on the interest rate swaps.

Value of the Planned Charges for Guarantees

4.49 An unadjusted value of the Planned Charges for Guarantees will be determined as the present value of all future proposed guarantee charges on Transferring Policies, which is to be taken to be 0.5% per annum of the asset shares of the Transferring Policies.

4.50 The calculation will be performed by ELAS using the ELAS actuarial model and the assumptions specified in the Scheme as the Stochastic Reserving Basis.

4.51 The value of the Planned Charges for Guarantees will then be determined by multiplying the unadjusted value of the Planned Charges for Guarantees by £63,700,000 and dividing by £64,200,000. I understand that the reason for this adjustment was that there was a small difference between the values calculated by ELAS and PAC reflecting minor modelling differences. The value of the Planned Charges for Guarantees determined by ELAS as at 31 December 2006 was £64,200,000 whereas the value determined by PAC was £63,700,000 and the parties agreed to adjust the figure calculated by ELAS to reflect that calculated by PAC.

Determination of the Mortality Premium

4.52 The Mortality Premium will be £17 million multiplied by the Aggregate Initial Asset Shares determined by ELAS using the ELAS Actuarial model as at the Effective date divided by £1,732,700,000 (the Aggregate Initial Asset Shares determined by ELAS using the ELAS Actuarial model as at 31 December 2006).

Timing of the asset allocations

4.53 On the Effective Date, the assets transferred to the WPSF and DCPSF of PAC will be based on estimates of the Aggregate Initial Asset Shares, the Up-front Guarantee Charge and the Mortality Premium agreed between ELAS and PAC in advance of the Effective Date. These estimates will be based on calculations of the equivalent amounts as at 30 June 2007 rolled forward to the Effective Date using a methodology agreed between ELAS and PAC.

4.54 Following the Effective Date, the Aggregate Initial Asset Shares, the Up-front Guarantee Charge and the Mortality Premium will be recalculated based on actual policy data as at the Effective Date.

4.55 On a date following agreement between ELAS and PAC of the final amounts, as at the Effective Date, of Aggregate Initial Asset Shares the Up-front Guarantee Charge and the Mortality Premium (the "Adjustment Payment Date"), adjustment payments will be made in cash between ELAS and the WPSF of PAC and between ELAS and the DCPSF of PAC to reflect differences between the estimates used to determine the transfers at the Effective Date and the final agreed amounts of the Aggregate Initial Asset Shares, the Up-front Guarantee Charge and the Mortality Premium. These

adjustment payments will be adjusted for interest at the base rate of HSBC Bank plc between the Effective Date and the Adjustment Payment Date. To the extent that the interest payable on any adjustment payment made by the DCPSF differs from the actual investment return earned on the additional assets held by the DCPSF, or the interest received by the DCPSF on any adjustment payment made to the DCPSF differs from the investment return credited by the DCPSF to asset shares in respect of the shortfall of assets held by the DCPSF, the difference will accrue to the WPSF.

Adjustment

4.56 As at the Effective Date, a percentage (the "Adjustment Percentage") will be determined such that if the Adjustment Percentage is applied to increase or reduce the non-guaranteed income on each Transferring Policy the aggregate of:

- the Aggregate Policy Value (defined as in paragraph 4.34) in respect of the non-guaranteed income under the Transferring Policies based on the assumptions, including mortality assumptions, set out in the Core Reserving Basis;
- the Up-front Guarantee Charge; and
- the Mortality Premium

each calculated after allowing for the adjustment of the non-guaranteed income by the Adjustment Percentage, will equal the WPA Allocated Amount.

4.57 If it is greater than 100%, the Adjustment Percentage will be applied to the non-guaranteed income on each Transferring policy on a date to be determined by PAC not more than two months after the Adjustment Payment Date. There will also be an enhancement to non-guaranteed bonuses in 2009 to compensate for the delay in applying the uplift to non-guaranteed income in 2008.

4.58 If the Adjustment Percentage is less than 100%, it will mean that the amounts of non-guaranteed income will exceed the amounts that the Aggregate Initial Asset Shares can support. The payments of income made in excess of those that could be afforded may be recovered by reducing future non-guaranteed bonuses on the Transferring Policies and/or, with the approval of the PAC With-Profits Committee, reducing the non-guaranteed income in respect of Transferring Policies.

4.59 The guaranteed income is not changed by the Percentage Uplift.

PART D - MISCELLANEOUS PROVISIONS OF THE SCHEME

Multi-Segment Policies

4.60 Certain ELAS policies ("Multi-Segment Policies") provide for benefits some of which are with-profits annuity benefits and some of which are annuity benefits which are not with-profits annuity benefits. The Transferring Policies shall only include the rights and liabilities under the Multi-Segment Policies to the extent that they relate to the

with-profits annuity benefits. Accordingly, ELAS and PAC shall, with effect from the Effective Date, become co-insurers of the Multi-Segment Policies with PAC being the insurer of the with-profits annuity benefits and ELAS being the insurer of the benefits which are not with-profits annuity benefits.

Excluded Policies

4.61 If any policies which the Scheme contemplates are to be transferred from ELAS to PAC cannot be so transferred, then those policies (the "Excluded Policies") will be retained by ELAS and reinsured on an original terms basis to PAC. The terms of the reinsurance will be such that the benefits payable under such policies will be identical to the benefits which would have been payable had the Excluded Policies been transferred to PAC under the terms of the Scheme. The Scheme amends the terms of the Excluded Policies so that they cease to have any entitlement to participate in the profits of ELAS whether by bonus or otherwise. The reinsurance liability will be allocated between the DCPSF of PAC and WPSF of PAC in the same way as if the Excluded Policies had been transferred to PAC under the terms of the Scheme.

4.62 In this report, when I refer to Transferring Policies, except where the context requires otherwise, I am referring to both Transferring Policies and any Excluded Policies.

Declaration of Trust by ELAS

4.63 If any assets which the Scheme contemplates are to be transferred from ELAS to PAC cannot be so transferred for any reason, they will be held in trust by ELAS for PAC until they can be transferred.

Indemnities

4.64 If any liabilities which the Scheme contemplates are to be transferred from ELAS to PAC cannot be so transferred for any reason, they will be retained by ELAS but will be indemnified by PAC.

Guernsey and Jersey policies

4.65 Transferring Policies issued or assumed by ELAS in Guernsey or Jersey will not be transferred under the terms of the Scheme presented to the High Court of Justice in England and Wales but will be the subject of schemes sanctioned under the relevant arrangements in those jurisdictions. Where such policies are transferred to PAC, they will be treated as if they had been transferred under the Scheme. The transfer of insurance business under the schemes in Guernsey and Jersey is the subject of a supplementary report to this report.

Bank mandates etc for the payment of annuities

4.66 Any mandate or other instruction in force on the Effective Date as to the manner of payment by ELAS of any sum payable under any Transferred Policy shall continue in force as an effective authority to the PAC.

Tax clearances

4.67 The Scheme will not proceed unless, on or prior to the Effective Date of the Scheme, tax clearances satisfactory in form and content to ELAS and PAC have been obtained.

Modifications and additions to the Scheme

4.68 After sanction of the Scheme, ELAS and PAC may apply jointly to the Court to amend its terms but only if (i) the Insurance Regulator is notified and given the right to be heard by the Court and (ii) an independent actuary has certified that the proposed amendment will not adversely affect the fair treatment of the holders of Transferred Policies.

Amendments to the Scheme

4.69 Subject to the approval of PAC's With-Profits Committee and prior notification to the FSA, the terms on which PAC is required by the Scheme to operate the Transferring Policies can be amended at any time to the extent required to enable PAC to comply with applicable law and regulation. The terms can also be amended:

- to facilitate a restructuring of the long-term business fund of PAC provided that the change is not to the material detriment of the Transferring Policies; or
- after 2009 for any reason provided that the change is not to the material detriment of the Transferring Policies.

provided always that there is no change to:

- the charges that may be applied to the asset shares of Transferring Policies;
- the requirements of the Scheme in respect of the mortality assumptions used in determining the non-guaranteed income attributable to Transferring Policies and the impact on Transferring Policies of changes in expected mortality;
- the deductions from bonuses on Deferred Cost Policies;
- the principle that income will be paid to holders of the Transferring Policies at a level calculated to exhaust the Transferring Policy Asset Shares over the lifetime of the Transferring Policies, allowing for PAC's expectations of future mortality; and
- the principle that the investment return credited to the asset shares of the Transferring Policies before deduction of charges and tax (other than

unrecoverable tax) and before smoothing will be the investment return earned on the backing assets (net of unrecoverable tax).

Relaxation of the Scheme

4.70 Other than clauses limiting the charges that can be made against the asset shares of the Transferring Policies as described in paragraph 4.9(c), PAC may elect for the Scheme to cease to apply at any time after the realistic liabilities have fallen below an amount equal to £100 million increased by the increase in the retail prices index from the Effective Date to the first day of the year of cessation. At such time, any positive amount allocated to the Smoothing Account shall be used to enhance the non-guaranteed income on transferring Policies.

Costs and expenses

4.71 Except as otherwise agreed between the parties, ELAS and PAC shall bear their own costs and expenses in relation to the preparation and carrying into effect of the Scheme, whether before or after the Effective Date.

Inherited estate of PAC

4.72 The Scheme states that the Transferring Policies will have no interest in any possible future distribution or reattribution of the inherited estate of PAC.

Interim Arrangements

4.73 Any interim bonus rates announced in respect of Transferring Policies by PAC in the period from 1 January 2008 to 31 March 2008 will have regard to both ELAS's best estimate of the non-guaranteed bonus rate to be announced by ELAS for the calendar year 2007 and PAC's best estimate of the interim bonus rate to be announced by PAC for the Transferring Policies having a policy anniversary in April 2008.

PART E - NOTIFICATION TO POLICYHOLDERS

Policyholder Circular

4.74 ELAS has prepared a document (the "Policyholder Circular") giving notice to policyholders of the proposed transfer of business and containing a summary of the Scheme and a summary of this report on the Scheme. The Policyholder Circular also gives details of how policyholders can obtain further information and informs policyholders of their right to make representations to the Court and the Royal Courts of Guernsey and Jersey as appropriate.

4.75 ELAS intends to send the Policyholder Circular to all its policyholders where it is reasonably practicable to obtain the current address of the relevant policyholder from its computer records.

4.76 PAC is applying to the Court for a waiver from the requirement to send the Policyholder Circular to its policyholders.

4.77 Notice of the proposed transfer of business will be published in a number of publications, including the London, Edinburgh and Belfast Gazettes and in the Financial Times (including International Editions of the Financial Times) and The Times newspapers. This notice will give the address from which any ELAS or PAC policyholder may obtain, free of charge, a copy of the Policyholder Circular, the Scheme and this report, and inform them of their right to object to the proposed Scheme.

5 Financial position of ELAS before and after implementation of the proposed Scheme

Financial position of ELAS before the proposed Scheme

5.1 Under the UK regulatory regime for insurers, larger with-profits firms are required to publish their solvency position using the so called "twin peaks" approach. This requires firms to carry out two separate calculations, referred to as the regulatory and the realistic peak, in respect of funds containing with-profits business and to hold sufficient capital to cover whichever calculation proves more onerous. For ELAS, the realistic peak was the more onerous at 31 December 2006 (and 2005).

5.2 Table 5.1 summarises the balance sheet of ELAS on the regulatory peak basis as at 31 December 2006 (and 31 December 2005), and also shows, on a pro-forma basis, the estimated impact of the transfer of most of ELAS's non-profit business to Canada Life Limited in February 2007 and the redemption of outstanding subordinated bonds which occurred later in 2007 (see paragraphs 2.11 and 2.13). The impact of the sale of ELAS's subsidiary, University Life to Reliance Mutual (see paragraph 2.12) is not reflected. For insurance liabilities, the regulatory value of liabilities represents the liability in respect of guaranteed liabilities and makes no explicit provision for non-guaranteed benefits.

Table 5.1: ELAS - Regulatory balance sheet

	31.12.06 Adjusted for post balance sheet events (£m)	31.12.06 Actual (£m)	31.12.05 Actual (£m)
Regulatory value of assets	10,085	14,401	15,488
Regulatory value of liabilities	(9,069)	(13,385)	(14,767)
Excess of assets over liabilities	**1,016**	**1,016**	**721**
Subordinated debt	0	167	167
Regulatory capital available	**1,016**	**1,183**	**888**
as % of regulatory value of liabilities	11.2%	8.8%	6.0%

5.3 Table 5.2 summarises ELAS's realistic balance sheet as at 31 December 2006 (and 31 December 2005), and also shows, on a pro-forma basis, the impact of the transfer of most of ELAS's non-profit business to Canada Life Limited. The redemption of outstanding subordinated bonds will have had no material impact on the excess of assets over liabilities. The impact of the sale of University Life to Reliance Mutual is not reflected.

Table 5.2: ELAS - Realistic balance sheet

	31.12.06 Adjusted for post balance sheet event (£m)	**31.12.06 Actual (£m)**	**31.12.05 Actual (£m)**
Regulatory value of assets	10,085	14,401	15,488
Less: Assets backing non profit (NP) business	(698)	(802)	(5,594)
Plus: Value of future profits on NP business	41	133	239
Realistic value of assets backing WP business	**9,428**	**13,732**	**10,133**
With-profits benefit reserve [(1)]	(7,559)	(7,559)	(8,181)
Plus: Planned deductions for guarantees [(2)]	288	288	300
Plus: Planned deductions for other costs [(3)]	50	50	46
Less: Future cost of guarantees [(4)]	(566)	(566)	(847)
Less: Future cost of financial options [(5)]	(9)	(9)	(10)
Less: Financing costs [(6)]	(4)	(4)	(11)
Less: Provisions for other liabilities [(7)]	(371)	(371)	(421)
Realistic value of current liabilities	(362)	(4,678)	(342)
Realistic value of with-profits liabilities	**(8,532)**	**(12,849)**	**(10,133)**
Working capital (excess of assets over liabilities)	**896**	**884**	**668**
Risk Capital Margin [(8)]	147	147	284
Surplus assets	**749**	**737**	**384**
as a % of realistic value of liabilities	8.8%	5.7%	3.8%

Notes to Table 5.2:

(1) The "with-profits benefit reserve" is the starting point for determining the policy related liabilities in respect of the with-profits business. It represents the aggregate of the Policy Values for AWP business and their equivalent for with-profits annuity business and other with-profits business (see Section 2).

(2) The "planned deductions for guarantees" represents the present value of projected future deductions from Policy Values or their equivalents for the cost of guarantees. It is assumed that the charge continues at its current level of 0.5% per annum in the future (see paragraph 2.51).

(3) The "planned deductions for other costs" represents the present value of the deductions ("financial adjustments") made to the Policy Values of policies that are surrendered (see paragraph 2.25).

(4) The "future cost of guarantees" is the present value of the projected future cost of guarantees where the basic guaranteed minimum benefits for a with-profits policy exceed those affordable from the Policy Value or its equivalent.

(5) The "future cost of financial options" represents the present value of the projected future costs of guaranteed annuity rates on certain policies.

(6) The "financing costs" represent the present value of the projected costs of servicing the subordinated bonds issued by ELAS in 1997. These costs will no longer apply since the bonds were redeemed in August 2007 (see paragraph 2.13).

(7) The "provisions for other liabilities" comprise a number of provisions for future liabilities. ELAS considers these provisions to have been established on a best estimate basis but with an element of prudence in some areas to allow for uncertainty.

(8) The Risk Capital Margin is a regulatory minimum level of capital. The Risk Capital Margin shown for 31 December 2006 after adjustment for post balance sheet events (unchanged from that before adjustment) is an approximation. Insurance firms are also required to meet capital requirements under the ICA framework (see paragraph 5.27).

5.4 ELAS's working capital (excess of assets over liabilities) will be distributed amongst the holders of its with-profits policies over the lifetime of those policies. Consequently, the realistic balance sheet published in ELAS's returns to the FSA shows the working capital as part of the realistic liabilities under the heading "planned enhancements to with-profits benefit reserve" and hence no excess of assets over liabilities. (The Risk Capital Margin is also shown as zero in the published returns to the FSA.)

The WPA Allocated Amount

5.5 As noted in paragraph 4.39, the assets to be transferred from ELAS to PAC (the WPA Allocated Amount) will be determined as at the Effective Date by ELAS as the sum of:

- that part of ELAS's "with-profits benefit reserve" which relates to the Transferring Policies;
- the excess of the "future cost of guarantees" in respect of the Transferring Policies over the "value of the planned deductions for the cost of guarantees" in respect of the Transferring Policies; and
- a share of the working capital of ELAS.

5.6 The "with-profits benefit reserve", "future cost of guarantees" and the "value of the planned deductions for the cost of guarantees" are to be determined by repeating the calculations carried out to produce the equivalent figures in ELAS's annual FSA

returns (which is the methodology used to produce the figures in Table 5.2). The assumptions used in these calculations, including the mortality assumptions, are based on current estimates of future experience and involve reasonable (but not excessively prudent) adjustments to reflect risk and uncertainty.

5.7 The starting point for determining the share of working capital to be transferred is to apply the proportion of the with-profits benefit reserve for all with-profits policies of ELAS represented by the with-profits benefit reserve of the Transferring Policies to the total working capital of ELAS (around 23% at 31 December 2006 but this proportion to be recalculated as at the Effective Date). However, there will then be adjustments made in order to, for example, allow for the fair allocation of the costs of the transaction and to compensate the remaining policyholders for diseconomies of scale. These adjustments, which are to be determined by ELAS, are discussed in more detail later in this Section.

5.8 ELAS's rationale for using with-profits benefit reserve as the starting point for the allocation of working capital was that:

- Policy Values or their equivalent (which is effectively the with-profits benefit reserve) have been used for many years by ELAS as the basis for determining the payouts on its with-profits policies;
- it is ELAS's established practice to apply any distribution of working capital in proportion to Policy Values or their equivalent ;
- Policy Values or their equivalent have been communicated to policyholders in the past and are therefore likely to be more familiar to them than alternative measures; and
- using the with-profits benefit reserve leads to similar results to other measures considered by ELAS.

5.9 ELAS has estimated that, had the Effective Date of the Scheme been 31 December 2006, the WPA Allocated Amount would have been £1,854 million, determined as shown in Table 5.3 below.

Watson Wyatt
Worldwide

Table 5.3: Pro-forma WPA Allocated Amount as at 31 December 2006

	(£m)
Realistic liabilities in respect of Transferring Policies	
With-profits benefit reserve	1,727
Plus: Future cost of guarantees	73
Less: Planned deductions from assets shares for guarantees	(62)
	1,738
Transferring Policies' share of Working Capital	
Unadjusted allocation of total working capital	205
Plus: Reversal of impact of transaction costs on unadjusted allocation	3
Less: Allocation of transaction costs	(30)
Plus: Allocation of margins in provisions	10
Less: Allowance for impact of transaction on future expenses of ELAS	(89)
Plus: Allocation of Mortality Premium	13
Plus: Allocation of future tax	1
Plus: Allocation of expense provisions	4
	117
Pro-forma WPA Allocated Amount	**1,854**(*)

(*) Total includes rounding of £(1) million.

5.10 As at 31 December 2006, the with-profits benefit reserve in respect of the Transferring Policies (£1,727 million) represented around 23% of the total with-profits benefit reserve.

5.11 For the purpose of the pro-forma calculation of the WPA Allocated Amount as at 31 December 2006, the starting point for determining the Transferring Policies share of the working capital (the "unadjusted allocation") was therefore to take around 23% of the total working capital (£896 million based on the figures adjusted for post balance sheet events in Table 5.2). This amounted to £205 million.

Adjustments to allow for an allocation of transaction costs

5.12 Costs of the transaction that have been incurred (or provided for) prior to the Effective Date will have reduced the working capital and hence will, in the unadjusted allocation of working capital, have been implicitly allocated between Transferring Policies and Remaining Policies in proportion to with-profits benefit reserve ("WPBR").

5.13 Since ELAS takes the view that a fair allocation of the costs of the transaction is different to an allocation based on WPBR, it is ELAS's intention that:

- the unadjusted allocation of working capital will be adjusted to reverse out the effect of transaction costs on the starting working capital; and

- a revised allocation of transaction costs (including an estimate of any transaction costs not yet incurred or provided for) will be determined by ELAS.

5.14 The transaction costs that had already been incurred or provided for at 31 December 2006 were £12.0 million. The amount added back to the unadjusted allocation of working capital is therefore around 23% of this; i.e. £2.7 million.

5.15 For the purpose of the pro-forma calculation of the WPA Allocated Amount as at 31 December 2006, ELAS has estimated that its total costs in respect of the Scheme and related transactions will be £35.2 million. These cost estimates currently comprise:

- £24.0 million of costs that ELAS considers to be directly attributable to the project to effect the proposed Scheme (e.g. employment costs in respect of contract staff to work on the project, costs incurred in developing systems and processes to effect the transfer and any break fee charged by HBOS for the loss of the contract to administer the Transferring Policies). ELAS considers that these costs should be allocated 100% to Transferring Policies, the holders of which it sees as the immediate beneficiaries of the transaction.
- £11.2 million of costs that ELAS considers to be attributable to development and implementation of the wider future strategy of ELAS - this transaction being a first step in that strategy. Costs that ELAS allocates to this category include costs related to the Extraordinary General Meeting at which ELAS members will vote on the proposed Scheme (e.g. printing and mailing of the Policyholder Circular and the hire of a venue) and costs incurred in determining the strategy and designing the Scheme (e.g. legal, actuarial and financial advisers' fees). ELAS considers that it would be unfair to allocate these costs 100% to Transferring Policies. However, ELAS also considers that it would be unfair to the remaining policyholders to allocate these costs in proportion to WPBR because the remaining policyholders are likely to suffer further costs incurred by ELAS in finding and implementing a long-term strategic solution for them. ELAS therefore considers, as a pragmatic approach, that these costs should be allocated 50% to Transferring Policies and 50% to Remaining Policies.

5.16 It should be noted that the £35.2 million costs that have been estimated could actually turn out to be materially different. In particular I understand that ELAS is currently in discussions with HBOS with regards to any break fee charged for the loss of the contract to administer the Transferring Policies.

5.17 In aggregate, £29.6m, representing 84% of the total estimated transaction costs, has been allocated to the Transferring Policies. Both the total amount of transaction costs and the proportion allocated by ELAS to the Transferring Policies might differ when the calculation is repeated as at the Effective Date.

Adjustment to allow for margins in provisions

5.18 ELAS considers that the "provisions for other liabilities" held on its realistic balance sheet as at 31 December 2006 include margins which are no longer necessary given a reduction in the level of uncertainty since the year end. In presenting the figures in Table 5.3, allowance has been made for the release of these margins.

5.19 ELAS does not anticipate that equivalent adjustments will be required at the Effective Date since the provisions for other liabilities on its balance sheet at the Effective Date are expected to be best estimates.

Adjustments to allow for an allocation of the Mortality Premium

5.20 As noted in Section 4 (paragraph 4.4), part of the assets transferred to PAC will be used to fund the Mortality Premium. Both Transferring Policies and those remaining in ELAS will benefit from the transfer of mortality risk to PAC since the Mortality Liabilities currently fall on all ELAS policies in proportion to their WPBR. With this in mind, ELAS considers it appropriate that the cost of the Mortality Premium should be allocated to the Transferring Policies and the Remaining Policies in proportion to their WPBR. Since the total Mortality Premium will be met from the allocation of working capital to the Transferring Policies, it is intended to increase the allocation of working capital to the Transferring Policies by the Remaining Policies' share of the Mortality Premium. As at 31 December 2006, this was around 77% of £17 million, i.e. £13 million.

Adjustment to compensate the Remaining Policies for diseconomies of scale

5.21 As noted in Section 2 (paragraph 2.47), ELAS makes a deduction of 1.0% per annum from Policy Values and their equivalents for expenses. In determining the realistic balance sheet, ELAS compares the present value of future expenses (net of tax) on a best-estimate basis with the present value of these future expense deductions. To the extent that there is a shortfall, a provision (the "expense overrun provision") is established.

5.22 The effect of the Scheme will be to increase the size of the expense overrun provision needed because the reduction in the present value of future expenses (net of tax) incurred by ELAS will be less than the reduction in the present value of the future expense charges received. This reflects the fact that a proportion of ELAS's expenses do not vary directly with the number of policies in-force.

5.23 It is intended that the unadjusted allocation of working capital to the Transferring Policies will be reduced by the increase in the expense overrun provision needed at the Effective Date. ELAS has performed calculations on a pro-forma basis as at 31 December 2006, which gave an adjustment as at that date of £89 million.

Adjustment to allow for an allocation of future tax

5.24 Tax payable by ELAS in respect of post 1991 UK with-profits purchase life annuities is currently charged to the working capital of ELAS. After the Effective Date such tax payable by PAC will be charged to the DCPSF and impact on future returns to Transferring Policies. It is proposed to make an addition to the WPA Allocated Amount in respect of the tax that would have been borne by the Remaining Policies share of the working capital. Had the Effective Date been 31 December 2006, it is estimated that this adjustment would have been £1 million.

Adjustment to allow for an allocation of expense provisions

5.25 To the extent that there are explicit expense provisions (other than the expense overrun provision referred to in paragraph 5.21) at the Effective Date for projects and activities to be undertaken after the Effective Date which will be for the sole benefit of the Remaining Policyholders, it is intended to increase the allocation of working capital to the Transferring Policies so that they do not effectively bear part of the cost of those projects or activities. Had the Effective Date been 31 December 2006, it is estimated that this adjustment would have been £4 million.

Financial position of ELAS after the proposed Scheme

5.26 Tables 5.4 and 5.5 show, on a pro-forma basis, the estimated impact of the Scheme on the regulatory balance sheet and the realistic balance sheet of ELAS had the transfer occurred at 31 December 2006. The "before Scheme" figures are those adjusted for the transfer of most of ELAS's non-profit business to Canada Life Limited and, in the case of the regulatory balance sheet, for the redemption of outstanding subordinated bonds, as shown in Tables 5.1 and 5.2.

Table 5.4: ELAS - Impact of Scheme on the regulatory balance sheet as at 31/12/06

	Before Scheme (£m)	**Change (£m)**	**After Scheme (£m)**
Regulatory value of assets	10,085	(1,854)	8,231
Regulatory value of liabilities	(9,069)	1,425	(7,644)
Excess of assets over liabilities	**1,016**	**(429)**	**587**
Subordinated debt	0		0
Regulatory capital available	**1,016**		**587**
as % of regulatory value of liabilities	11.2%		7.7%

Table 5.5: ELAS - Impact of the Scheme on the realistic balance sheet as at 31/12/06

	Before Scheme (£m)	Change (£m)	After Scheme (£m)
Regulatory value of assets	10,085	(1,854)	8,231
Less: Assets backing non profit (NP) business	(698)		(698)
Plus: Value of future profits on NP business	41		41
Realistic value of assets backing WP business [1]	**9,428**	**(1,854)**	**7,574**
With-profits benefit reserve [2]	(7,559)	1,727	(5,832)
Plus: Planned deductions for guarantees [3]	288	(62)	226
Plus: Planned deductions for other costs	50		50
Less: Future cost of guarantees [4]	(566)	73	(493)
Less: Future cost of financial options	(9)		(9)
Less: Financing costs	(4)		(4)
Less: Provisions for other liabilities [5]	(371)	(112)	(483)
Realistic value of current liabilities	(362)		(362)
Realistic value of with-profits liabilities	**(8,532)**	**1,625**	**(6,907)**
Working capital (excess of assets over liabilities)	**896**	**(229)**	**667**
as a % of realistic value of liabilities	10.5%		9.7%

Notes to Table 5.5:

(1) The reduction in the "realistic value of assets backing WP business" represents the WPA Allocated Amount (£1,854 million - see paragraph 5.9).

(2) The change in the "with-profits benefit reserve" represents the with-profits benefit reserve in respect of the Transferring Policies (see Table 5.3).

(3) The change in the "planned deductions for guarantees" represents the planned deductions for guarantees in respect of the Transferring Policies (see Table 5.3).

(4) The change in the "future cost of guarantees" represents the future cost of guarantees in respect of the Transferring Policies (see Table 5.3).

(5) The increase in "provisions for other liabilities" represents the increase in the required provision for future expenses (£89 million - see paragraphs 5.21 to 5.23) and a provision for estimated transaction costs not already reflected in the realistic balance sheet at 31 December 2006 (£23 million being £35 million total transaction costs less £12 million already reflected - see paragraphs 5.14 and 5.15).

Individual Capital Assessment (ICA)

5.27 In addition to producing the published statement of solvency, insurance firms are required to prepare a confidential assessment of their capital needs under the Individual Capital Adequacy (ICA) framework. Upon receipt of this assessment the FSA may issue a confidential Individual Capital Guidance (ICG) which may result in a required level of capital in excess of the ICA calculated by the firm itself.

5.28 It is for the individual firm to decide the level of capital that it needs. However, the minimum level of capital acceptable to the FSA is that which would be sufficient to be able to continue to hold realistic reserves in adverse scenarios with 99.5% certainty over one year.

5.29 ELAS has estimated the impact of the proposed Scheme on its ICA position. These calculations demonstrate that ELAS has sufficient capital to meet its ICA capital requirement with a margin both before and after implementation of the Scheme although there is a reduction in the excess of available capital over the ICA capital requirement.

5.30 This reduction in ICA cover arises largely because the contribution to available capital from the ability to reduce (or eliminate) non-guaranteed bonuses on with-profit annuities in adverse scenarios will be lost following the transfer of this business to PAC.

6 Financial position of PAC before and after implementation of the proposed Scheme

Financial position of PAC before the proposed Scheme

6.1 Table 6.1 summarises the balance sheet of PAC on the published regulatory peak solvency basis. For insurance liabilities, the regulatory value of liabilities represents the liability in respect of guaranteed liabilities and makes no explicit provision for non-guaranteed benefits.

Table 6.1: PAC - Regulatory balance sheet

	31.12.06 (£m)	**31.12.05 (£m)**
Long-term fund		
Regulatory value of assets	103,715	99,193
Regulatory value of liabilities	(76,839)	(77,479)
Excess of assets over liabilities	**26,876**	**21,714**
Shareholders' fund		
Regulatory value of assets	903	868
Technical provisions for non life business	(117)	(129)
Other liabilities	(57)	(73)
Shareholder net assets	**729**	**666**
Regulatory capital available	**27,605**	**22,380**
as % of regulatory value of liabilities	35.9%	28.9%

6.2 The realistic peak was more onerous than the regulatory peak at 31 December 2006 (and 2005) for each of the WPSF, DCPSF and SAIF.

6.3 Tables 6.2, 6.3 and 6.4 summarise the realistic balance sheets as at 31 December 2006 (and 31 December 2005) for the DCPSF, WPSF and SAIF respectively.

6.4 The zero result for the excess of assets over liabilities in Table 6.2 reflects the assumption that, for the DCPSF, bonuses will be declared so as to extinguish the Fund over the outstanding term of the in-force business.

Table 6.2: PAC DCPSF - Realistic balance sheet

	31.12.06 (£m)	31.12.05 (£m)
Regulatory value of assets	1,575	1,307
Plus: Value of future profits	0	0
Realistic value of assets	**1,575**	**1,307**
With-profits benefit reserve	(1,574)	(1,302)
Plus: Planned deductions for guarantees	61	40
Less: Future cost of guarantees	(31)	(13)
Less: Other liabilities	(30)	(27)
Realistic value of current liabilities	(1)	(5)
Realistic value of liabilities	**(1,575)**	**(1,307)**
Excess of assets over liabilities	**0**	**0**
Risk Capital Margin	0	0

Table 6.3: PAC WPSF - Realistic balance sheet

	31.12.06 (£m)	31.12.05 (£m)
Regulatory value of assets	76,133	72,135
Plus: Adjustment for shares in subsidiaries	361	396
Plus: Value of future profits on non-profit business	448	666
Realistic value of assets	**76,942**	**73,197**
With-profits benefit reserve	(62,713)	(59,888)
Less: Past miscellaneous surplus attributed to asset shares	(47)	
Less: Planned enhancements to asset shares	(362)	(369)
Plus: Planned deductions for guarantees	1,165	1,105
Plus: Other planned deductions from asset shares	94	67
Less: Future cost of guarantees	(1,278)	(1,398)
Less: Future cost of financial options	(47)	(52)
Less: Future costs of smoothing	(184)	(481)
Less: Other liabilities	(1,514)	(1,069)
Realistic value of current liabilities	(3,436)	(3,132)
Realistic value of liabilities	**(68,322)**	**(65,218)**
Excess of assets over liabilities	**8,619**	**7,979**
Risk Capital Margin	(1,818)	(1,795)
Surplus assets	**6,801**	**6,184**
as % of realistic value of liabilities	10.0%	9.5%

Table 6.4: PAC SAIF - Realistic balance sheet

	31.12.06 (£m)	31.12.05 (£m)
Regulatory value of assets	14,321	14,354
Plus: Value of future profits on non-profit business	323	451
Realistic value of assets	**14,644**	**14,805**
With-profits benefit reserve	(12,483)	(12,609)
Less: Planned enhancements to asset shares	(205)	(198)
Plus: Planned deductions for guarantees	328	332
Plus: Other planned deductions from asset shares		
Less: Future cost of guarantees	(84)	(175)
Less: Future cost of financial options	(561)	(619)
Plus/minus: Future costs of smoothing	83	(68)
Less: Other liabilities	(210)	(134)
Realistic value of current liabilities	(612)	(638)
Realistic value of liabilities	**(13,745)**	**(14,108)**
Excess of assets over liabilities	**899**	**697**
Risk Capital Margin	526	645
Surplus assets	**373**	**52**
as % of realistic value of liabilities	2.7%	0.4%

Notes to Table 6.4:

(1) The excess of assets over liabilities will be distributed amongst the holders of with-profits policies over the lifetime of the policies. Hence the realistic balance sheet for the SAIF published in PAC's returns to the FSA show the excess of assets over liabilities as part of the realistic liabilities under the heading "Planned enhancements to asset shares" and a Risk Capital Margin of zero.

(2) The relatively low level of surplus assets as a % of liabilities is a reflection of the fact that the SAIF is provided with financial support from the WPSF (see paragraph 3.22).

Individual Capital Assessment

6.5 As at 31 December 2006, PAC had sufficient capital to cover its ICA and ICG with a comfortable margin.

Impact of the Scheme on the DCPSF

6.6 Had the Effective Date been on 31 December 2006, both the assets and liabilities of the DCPSF would have increased by the amount of the Aggregate Initial Asset Shares, estimated to be £1,793 million determined as the estimate of the WPA Allocated Amount (£1,854 million - see paragraph 5.9) less the amounts allocated to the WPSF (£61 million - see paragraph 6.9). This estimate of the Aggregate Initial Asset Shares represents an augmentation of a little under 4% to ELAS's calculation of the with-profits benefit reserve (the equivalent to Policy Value or asset share in ELAS) in respect of the Transferring Policies before augmentation (£1,727 million). However, based on the Core Reserving Basis as defined in the Scheme (which is slightly different to the basis adopted by ELAS in determining its with-profits benefit reserve), this level of augmentation of asset shares would have resulted in an uplift to non-guaranteed income of around 3.5%.

6.7 Table 6.5 shows, on a pro-forma basis, the estimated impact of the Scheme on the realistic balance sheet of the DCPSF. The assets allocated to the DCPSF represent ELAS's estimate of the WPA Allocated Amount less ELAS's estimate of the amount to be allocated to the WPSF (see paragraph 6.9).

Table 6.5: PAC DCPSF - Impact of Scheme on realistic balance sheet as at 31/12/06

	Before Scheme (£m)	Change (£m)	After Scheme (£m)
Regulatory value of assets	1,575	1,793	3,368
Plus: Value of future profits	0		0
Realistic value of assets	**1,575**	**1,793**	**3,368**
With-profits benefit reserve	(1,574)	(1,793)	(3,367)
Plus: Planned deductions for guarantees	61		61
Less: Future cost of guarantees	(31)		(31)
Less: Other liabilities	(30)		(30)
Realistic value of current liabilities	(1)		(1)
Realistic value of liabilities	**(1,575)**	**(1,793)**	**(3,368)**
Excess of assets over liabilities	**0**		**0**

6.8 As is the case before implementation of the Scheme (see paragraph 6.4) there is no reported excess of assets over liabilities because the intention is that bonuses will be declared so as to extinguish the Fund over the outstanding term of the in-force business.

Impact of the Scheme on the WPSF

6.9 Had the Effective Date been on 31 December 2006, it has been estimated that the WPSF would have been impacted by the Scheme as described below.

6.10 As at the Effective Date, the assets of the WPSF would have increased by around £61 million being approximately:

- £18 million in respect of the Mortality Premium; and
- £43 million in respect of the Up-front Guarantee Charge

These are figures estimated by ELAS.

6.11 Subsequently, the WPSF will receive charges for guarantees on the Transferring Policies. The value of the planned charges for guarantees determined on the basis used by PAC to determine its realistic balance sheet has been estimated to be around £66 million.

6.12 The cost of guarantees on the Transferring Policies determined on the basis used by PAC to determine its realistic balance sheet has been estimated to be around £122,000,000 as at 31 December 2006. This can be compared to the Up-front Guarantee Charge and the value of the planned charges for guarantees, which in aggregate amount to £109 million. The difference reflects the compromise between the valuation of the cost of guarantees by PAC and by ELAS referred to in Section 4 and the calibration amount to allow for a different definition of the risk free rate of investment return (see paragraphs 4.47 and 4.48).

6.13 The WPSF may also be impacted after the Effective Date as a result of having provided the cap and floor protection to the holders of Transferring Policies from material changes in future mortality assumptions. I understand that, as at the Effective Date, PAC does not expect this arrangement to be treated as either an asset or liability in the realistic balance sheet of the WPSF.

6.14 Other impacts of the Scheme on the WPSF are:

- the potential impact of any mortality profits and losses resulting from mortality experience different to that assumed in setting non-guaranteed income levels on Transferring Policies; and
- the potential impact of operating a smoothing account in respect of the Transferring Policies.

Both of these are expected to have a neutral effect over time and will not therefore impact on the realistic balance sheet of the WPSF on the Effective Date.

6.15 Table 6.6 shows, on a pro-forma basis, the estimated impact of the Scheme on the realistic balance sheet of the WPSF had the transfer occurred at 31 December 2006.

Table 6.6: PAC WPSF – Impact of Scheme on realistic balance sheet as at 31/12/06

	Before Scheme (£m)	Change (£m)	After Scheme (£m)
Regulatory value of assets	76,133	61	76,194
Plus: Adjustment for shares in subsidiaries	361		361
Plus: Value of future profits	448		448
Realistic value of assets	**76,942**	**61**	**77,003**
With-profits benefit reserve	(62,713)		(62,713)
Less: Past miscellaneous surplus attributed to asset shares	(47)		(47)
Less: Planned enhancements to asset shares	(362)		(362)
Plus: Planned deductions for guarantees	1,165	66	1,231
Plus: Other planned deductions from asset shares	94		94
Less: Future cost of guarantees	(1,278)	(122)	(1,400)
Less: Future cost of financial options	(47)		(47)
Less: Future costs of smoothing	(184)		(184)
Less: Other liabilities	(1,514)		(1,514)
Realistic value of current liabilities	(3,436)		(3,436)
Realistic value of liabilities	**(68,322)**	**(56)**	**(68,378)**
Excess of assets over liabilities	**8,619**	**5**	**8,624**
Risk Capital Margin	(1,818)	(165)	(1,983)
Surplus assets	**6,801**	**(160)**	**6,641**
as % of realistic value of liabilities	10.0%		9.7%

6.16 The above table indicates that there is expected to be little change (a small increase of £5 million based on the illustrative figures as at 31 December 2006 above) in the reported working capital (excess of assets over liabilities) in the WPSF. This reflects the excess of the cost of guarantees over the value of planned charges for guarantees and Up-front Guarantee Charge on the one hand (see paragraph 6.12) and the receipt of the Mortality Premium with no corresponding liability on the other (see paragraph 6.13).

6.17 Table 6.4 also shows an increase in the capital requirements of the WPSF (Risk Capital Margin). This reflects the additional risks that the Fund is taking on. PAC will compensate the WPSF for providing capital to support the risks it is taking on in respect of the Transferring Policies by making payments from the NPSF (i.e. at the

cost of shareholders) equal to 0.14% per annum of asset shares. I understand that this is based on the estimated cost of providing such support in relation to assessed ICA capital requirements. The present value of all future capital charges payable to the WPSF in respect of the Transferring Policies has been estimated by PAC to be £18m.

6.18 While there is no obligation in the Scheme for PAC to make these capital charges to the WPSF, I understand (and it is confirmed by the Actuarial Function Holder of PAC in his report on the Scheme) that these charges will be made and that reference will be made to this in PAC's published Principles and Practices of Financial Management ("PPFM").

Individual Capital assessment (ICA)

6.19 PAC has estimated the impact of the proposed Scheme on its ICA position. These calculations demonstrate that PAC has sufficient capital to continue to comfortably meet its ICA capital requirement after implementation of the Scheme.

7 Implications for the holders of Transferring Policies

7.1 In this section of my report, I consider the likely effects of the proposed Scheme on the holders of Transferring Policies. In particular, I consider:

- the security of policyholders' benefits; and
- policyholders' reasonable benefit expectations.

Security of benefits

7.2 The security of policyholders' benefits is derived from the strength of the reserves established for the liabilities in the long-term insurance fund and the extent to which the value of the assets of the company exceed the value of its liabilities.

7.3 ELAS has a single long-term insurance fund (and no sub-funds) and, as a mutual, has no shareholder assets. The security for guaranteed benefits is therefore provided by surplus assets in the fund and margins in the mathematical reserves.

7.4 As a proprietary company, PAC maintains a long-term insurance fund separate from its other funds. This is a legal requirement and there are constraints on amounts that can be charged to the long-term insurance fund and on transactions between the shareholders' fund and the long-term insurance fund. In particular, the assets of the long-term insurance fund must be used for the purpose of the company's long-term insurance business. In providing for the security of guaranteed benefits, however, the assets of the shareholders' fund are also available to meet the long-term business liabilities if needed.

7.5 As noted in Section 3, the long-term insurance fund of PAC is sub-divided into a number of sub-funds. In extreme circumstances, the distinction between the sub-funds would break down and the assets of one sub-fund could be used to meet the liabilities of another. When considering the security of the guaranteed benefits, it is therefore appropriate to have regard not only to the financial strength of the WPSF, which is the fund which will meet the cost of guarantees on the Transferring Policies in normal circumstances, but also to the financial strength of PAC as a whole.

7.6 It is evident from the analysis of PAC's financial position in Section 6 that PAC is a financially strong company. As at 31 December 2006, it had an excess of assets over liabilities on a regulatory peak basis of £27.6 billion, representing 36% of its liabilities, which is a measure of its ability to meet guaranteed liabilities. This can be compared with an excess of assets over liabilities on a regulatory peak basis in ELAS (adjusted for certain post balance sheet events) of £1.0 billion, which represented only 11% of its liabilities.

7.7 The Transferring Policies are currently exposed to a number of different risks in ELAS including market risk, credit risk, insurance risk (including mortality risk), operational risk (including expense risk) and legal and regulatory risks.

7.8 On transferring to PAC, the Transferring Policies will be in a company exposed to generally similar types of risks to ELAS. In addition, PAC is exposed to risks associated with seeking and writing new business and has a greater exposure to market risk due to the higher equity backing ratio in its WPSF. PAC's greater exposure to equity type investments is likely to lead to greater volatility of returns albeit that, over the long-term, it may be expected that these asset types will outperform lower risk assets such as fixed interest investments and cash. PAC is able to invest a significant proportion of its assets in equity type investments because of the strength of its WPSF.

7.9 It is a requirement of the Scheme that Transferring Policies are not exposed to, and shall incur no adjustment for profits or losses arising from PAC's other policies, experience or business activities. The Transferring Policies will therefore only be exposed to many of the risks in PAC in extreme situations when PAC is unable to meet or reserve for its guaranteed liabilities. Following implementation of the Scheme, with the limited exception referred to in paragraph 4.10, the Transferring Policies will also no longer be exposed to any risks in ELAS including liabilities arising from acts or omissions of ELAS in relation to the Transferring Policies (including, for example, mis-selling liabilities or liabilities arising from breaches of policy conditions or regulatory requirements) which will remain in ELAS.

7.10 As noted in Section 6 (see Table 6.6), on a pro-forma basis following the implementation of the Scheme, had this taken place as at 31 December 2006, the PAC WPSF would have had surplus assets in excess of its Risk Capital Margin (a regulatory capital requirement that reflects, among other things, the level of equity type investments held by the Fund) of £6.6 billion, representing around 10% of realistic liabilities.

7.11 Taking into account the above factors and the financial position of ELAS before the Scheme (see Section 5), it is my view that the security of the Transferring Policies' guaranteed benefits will be enhanced by the Scheme.

Policyholders' benefit expectations

7.12 The level of the income payable under a Transferring Policy is determined as the greater of the guaranteed income and non-guaranteed income applicable to the policy. This is the current position in ELAS and will continue to be the position following the transfer to PAC.

Guaranteed income

7.13 Each Transferring Policy will have the same level of guaranteed income immediately following the Effective Date as it had immediately before the Effective Date.

7.14 After the Effective Date, consistent with the contractual terms, and unchanged from the current position in ELAS, the guaranteed income on each Transferring Policy will

typically reduce each year by any ABR applicable to that Policy and increase by any guaranteed bonuses declared.

7.15 Since 2000, ELAS has not declared any bonuses in guaranteed form. ELAS has also indicated that there is no expectation of any further guaranteed bonuses being awarded in the foreseeable future. This reflects the fact that as at 31 December 2006, around 47% of the Transferring Policies had guaranteed income in excess of non-guaranteed income.

7.16 Following the Effective Date, PAC will determine any guaranteed bonuses declared on the Transferring Policies. The Scheme places no obligations on PAC with regard to the declaration of guaranteed bonuses and I understand that PAC considers it unlikely that it will declare any such bonuses except, maybe, in the event of sustained favourable investment performance. Given the current expectations of the holders of Transferring Policies, I do not consider this to represent a detrimental effect on policyholders expectations.

Non-guaranteed income

7.17 Each Transferring Policy will have the same level of non-guaranteed income immediately following the Effective Date as it had immediately before the Effective Date. The GIR and ABR associated with each policy are both unchanged by the Scheme.

7.18 Consistent with the position currently, the non-guaranteed income associated with each Transferring Policy will reduce each year by the combined effect of the GIR and ABR before any adjustment for non-guaranteed bonus reflecting investment return, net of charges, is applied.

7.19 I understand that either ELAS will announce a non-guaranteed bonus rate for 2007 prior to the Effective Date or PAC will announce a non-guaranteed bonus rate in respect of Transferring Policies for 2007 during 2008 which reflects the non-guaranteed bonus rate subsequently announced by ELAS for 2007. The change in non-guaranteed income at the policy anniversary of Transferring Policies having a policy anniversary after the Effective Date but before the non-guaranteed bonus for 2007 is announced will reflect ELAS's best estimate of the non-guaranteed bonus to be announced for 2007. In having regard to the period between the Effective Date and the Transferring Policies' policy anniversary, such changes in non-guaranteed income will also reflect PAC's best estimate of the interim bonus it will announce in respect of Transferring Policies having a policy anniversary in April 2008 (at which time the actual non-guaranteed bonus for 2007 will be known).

7.20 The development of the non-guaranteed income currently depends on:

- the investment return on the assets backing the policies;
- charges for expenses;
- charges for guarantee costs;
- assumptions about future mortality experience (and actual mortality experience);
- distributions of working capital; and
- smoothing.

7.21 I consider the position of the holders of Transferring Policies before and after implementation of the Scheme in respect of each of these items below and then consider the overall impact on policyholders' reasonable benefit expectations.

Investment return on with-profits assets

7.22 Investment return will be the primary driver of the future development of non-guaranteed income on the Transferring Policies and a significant factor affecting the investment return will be the investment mix of the assets backing the policies. In ELAS, as at 31 December 2006, the majority of the with-profits assets were invested in fixed interest securities and cash. The proportion of the assets backing the Transferring Policies invested in equities and property (the "equity backing ratio") was around 15% at 31 December 2006 (see paragraph 2.55) and the current target equity backing ratio is 20%.

7.23 When the holders of Transferring Policies took out their Policies with ELAS, the equity backing ratio was much higher than it is now (see paragraph 2.56 and Table 2.3). I understand that, while ELAS considers it possible that, in the absence of the Scheme, the target equity backing ratio could increase from 20%, significant increases are unlikely. In particular the equity backing ratio is never likely to increase to the sort of levels it was at when holders of Transferring Policies took out their policies. The current low equity backing ratio and target equity backing ratio are a reflection of ELAS's relatively weak solvency position.

7.24 Following implementation of the Scheme, the asset mix backing the asset shares of the Transferring Policies will initially be identical to the asset mix of the pool of assets used to back the majority of PAC's with-profits policies in its WPSF. As at 31 December 2006, this had an equity backing ratio of around 68% (see paragraph 3.30). This reflects the greater financial strength of the WPSF of PAC and the consequent greater investment freedom available to PAC. The current target equity backing ratio set by the PAC Board is 70%. The actual equity backing ratio and this target equity backing ratio may vary in the future but are likely to remain significantly higher than the equity backing ratio that would apply to the Transferring Policies if they were to remain in ELAS.

7.25 Over the long-term, equity-type assets are generally expected to out-perform fixed interest and cash assets, which would result in the holders of Transferring Policies receiving higher non-guaranteed income. It should be noted however that out-performance is not certain and the greater exposure to equities and property is likely to give rise to more volatility of underlying investment returns.

7.26 While there is this likelihood of greater volatility of returns and a possibility that investment performance could be worse following the transfer than it would have been in the absence of the transfer, generally accepted views would support the greater exposure to equity-type investments in PAC being a benefit to the policyholders of Transferring Policies. This greater exposure is also likely to be more consistent with the original expectations of the holders of Transferring Policies when taking out their policy.

Charges for expenses and taxation

7.27 The current deduction for expenses from the investment return allocated to Transferring Policies is 1% per annum and the Board of ELAS has indicated that it will aim to maintain the expense deduction at this level. However, if actual expenses are greater (or less) than can be met from this 1% per annum charge against the investment return allocated to Transferring Policies and on Policy Values of other with-profits policies and an existing provision for an expense overrun, the overrun or underrun will impact on the working capital available for distribution as future enhancements to income.

7.28 Following the implementation of the Scheme, expense charges will effectively be fixed at 1% per annum and allocated to the NPSF of PAC. The Transferring Policyholders will no longer have any exposure to expense risk or reward, which will instead be allocated to PAC shareholders.

7.29 Although the holders of Transferring Policies will lose any possible upside from possible future efficiency improvements in ELAS, compared to the uncertainty of future expense levels in a closed fund such as ELAS, I believe that the certainty of a fixed expense charge is beneficial to the holders of Transferring Policies.

Charges for the cost of guarantees

7.30 The current level of charges made on Transferring Policies for the cost of guarantees is 0.5% per annum. Depending on experience, this charge could either increase or reduce in future in ELAS. Following implementation of the Scheme, this charge will be capped at 0.5% per annum in PAC.

7.31 There are also provisions in the Scheme (see paragraphs 4.14 to 4.16), which will ensure that, if PAC reduces or increases the target equity backing ratio of the assets backing the Transferring Policies, or changes the charges for guarantees on its other

with-profits policies, there will be a review, on a consistent basis, of the charges for guarantees made on the Transferring Policies.

7.32 I believe that the certainty offered by a capped charge for the cost of guarantees is a material benefit for the holders of Transferring Policies.

Impact of changes in assumptions about future mortality experience

7.33 The realistic liability in respect of the current level of non-guaranteed income on a Transferring Policy is dependent on the assumptions made about future annuitant mortality (i.e. the expected future lifetime of the Policyholder). Mortality has been improving for many years and is expected to continue to improve in future. In determining the realistic liability for the Transferring Policies, ELAS makes assumptions which include an allowance for future improvements in mortality experience. PAC, similarly, will make allowance for future mortality improvements in its management of the Transferring Policies following the transfer of business.

7.34 In determining the Adjustment Percentage (see paragraphs 4.56 to 4.58) and consequently the non-guaranteed income on Transferring Policies to apply from the Income Uplift Date (expected to be around 6 to 9 months after the Effective Date), the mortality assumptions adopted will be as defined in the Core Reserving Basis in the Scheme. As noted in paragraph 6.6, while, on the basis of pro-forma figures as at 31 December 2006, the Initial Aggregate Asset Shares in respect of the Transferring Policies would have included an augmentation to the Policy Values of Transferring Policies as determined by ELAS of a little under 4%, the resultant uplift to non-guaranteed income would only have been around 3.5%. The reason for this is that there is a difference between the mortality assumptions used by ELAS in determining Policy Values and the mortality assumptions in the Core Reserving Basis in the Scheme. Based on the Core Reserving Basis, to afford the actual level of non-guaranteed income in respect of Transferring Policies as at 31 December 2006, the asset shares would have needed to be £1,733 million whereas the Policy Values established by ELAS were only £1,727 million.

7.35 Views on future mortality and, in particular, on the rate of improvements in mortality of annuitants evolve continuously. I understand that as at 31 December 2006, the assumptions in the Core Reserving Basis were those which, as at that date, PAC would have intended to use in the management of the Transferring Policies. While in determining the amount of any uplift to non-guaranteed income from the Income Uplift Date, the mortality assumptions used must be those in the Core Reserving Basis, PAC will most likely amend these assumptions thereafter, and quite possibly from shortly after the implementation of the Scheme. Subject to the factors described below, it is possible that any such revision to the mortality assumptions will result in a reduction in non-guaranteed income or lower non-guaranteed bonuses being announced.

7.36 The Scheme does however provide some protection to the holders of Transferring Policies in that it requires that the PAC shall use mortality bases for expected mortality during the remaining lifetimes of the Transferring Policies which the With-Profits Committee has confirmed in advance, at least annually, to be best estimate bases for the Transferring Policies (without any known margins for prudence).

7.37 In ELAS, if there is a strengthening of the annuitant mortality assumptions (i.e. if it is assumed that the holders of Transferring Policies will live longer), there is no direct impact on the amount of non-guaranteed income payable to the holder of a Transferring Policy. There is however an indirect impact in that the consequent increase in the realistic liability would be charged to the working capital. This, in turn, would either reduce enhancements to non-guaranteed income made by way of a distribution of the working capital or, if the increase in realistic liability left the working capital insufficient to meet the capital needs of ELAS, require increased deductions from the investment return allocated to Policy Values and hence, in the case of Transferring Policies, reductions in non-guaranteed income.

7.38 Conversely, if there is a weakening of the annuitant mortality assumptions (i.e. if it is assumed that the holders of Transferring Policies will live less long), the consequent reduction in the realistic liability would accrue to the working capital, which, in turn, would enable increased enhancements to non-guaranteed income made by way of a distribution of the working capital.

7.39 The cost or benefit of changes in annuitant mortality is shared amongst all with-profits policies in ELAS, including policies that are not with-profits annuities, in proportion to their Policy Values or equivalents. The cost or benefit accruing to holders of Transferring Policies would therefore only be, currently, around 23% of the total cost or benefit; the balance of the cost or benefit accruing to the holders of Remaining Policies.

7.40 By contrast, following the implementation of the Scheme, the cost or benefit arising from changes to the assumptions about future annuitant mortality applicable to the Transferring Policies will impact directly and, subject to a cap and floor, accrue 100% to the holders of Transferring Policies.

7.41 The cap and floor is explained in Section 4 (paragraphs 4.32 to 4.36). Broadly, it will limit the impact on non-guaranteed income of changes in mortality experience from mortality assumptions specified in the Scheme to the equivalent of an addition to, or deduction from, the annual amount of non-guaranteed income of 0.5% per annum.

7.42 To summarise, the holders of Transferring Policies are currently exposed to around 23% of the impact of changes in mortality assumptions applicable to their Policies

without limit. Following the implementation of the Scheme, they will be exposed to 100% of the impact but with a cap and floor.

7.43 It is impossible to predict future rates of mortality with certainty and the cap and floor could therefore result in either a benefit or a cost to the holders of Transferring Policies compared to the position in the absence of the cap and floor. However, I believe that the limits on this uncertainty resulting from the cap and floor is a positive feature of the Scheme for the holders of Transferring Policies.

Impact of variation of mortality experience from the assumptions made

7.44 In the preceding paragraphs, I considered the impact of changes in assumptions about future mortality on the level of non-guaranteed income on Transferring Policies. It is also necessary to consider the impact of differences between actual experience and the assumptions made.

7.45 In ELAS, any such differences result in profits or losses which accrue to the working capital and are subsequently allocated between all with-profits policies in proportion to their Policy Values or equivalents; i.e. the holders of Transferring Policies will be exposed to, currently, around 23% of any such profits or losses.

7.46 After the Effective Date, any profits or losses from this source will accrue to the WPSF of PAC and have no impact on the holders of Transferring Policies. If the assumptions made about future mortality (and, in particular, short term future mortality) are always best-estimates, the position should be broadly neutral. Given the requirement for PAC to use best estimate mortality bases for expected mortality (see paragraph 7.36), I believe the fact that mortality profits and losses arising from differences between actual and expected mortality will accrue to the WPSF and not to Transferring Policies should have no material impact on Transferring Policies.

Distribution of working capital

7.47 In considering the implications of the Scheme on the Transferring Policies, it is necessary to consider the impact of the Scheme on both the amount of ELAS's working capital allocated for the benefit of the Transferring Policies and the timing of its distribution.

Allocation of working capital to the Transferring Policies

7.48 As discussed in paragraph 2.45, ELAS intends that all of its assets, after providing for its contractual liabilities, will be distributed as fairly as possible amongst the existing holders of its with-profits policies over the lifetime of those policies. In the absence of the Scheme, these assets (ELAS's "working capital") would be distributed by way of enhancements to non-guaranteed bonuses over time. It is ELAS's established practice to make distributions of working capital in proportion to Policy Values or their equivalents. Since the equivalent to Policy Values for Transferring Policies (referred

to subsequently in this Section simply as the Policy Values of Transferring Policies) represented around 23% of total Policy Values at 31 December 2006 and projections show that this proportion is not expected to change materially over the next 20 years, in the absence of the Scheme, the holders of Transferring Policies might reasonably have expected to share in around 23% of the working capital (which represents around 12% of their aggregate Policy Values). It should be noted however that the working capital in ELAS is at risk of depletion from unforeseen costs or increases in foreseen costs and its availability for distribution is therefore not certain.

7.49 Under the terms of the Scheme, there will be an allocation of the working capital of ELAS between that part which transfers to PAC with the Transferring Policies and that part which remains in ELAS with the Remaining Policies. The Scheme does not fully define the method of determining the allocation of the working capital of ELAS between the Transferring Policies and the Remaining Policies, leaving the ELAS Board with some discretion over the precise allocation as at the Effective Date. The proposed methodology, as described in Section 5, is that currently recommended to the ELAS Board by the With-Profits Actuary of ELAS, who notes in his report on the impact of the proposed transfer on ELAS's policyholders that the primary requirement in determining the allocation should be that the calculation of the Transferring Policies' share of working capital must be fair between different groups of policyholders.

7.50 The starting point for the allocation of working capital is to apportion it between Transferring Policies and Remaining Policies in proportion to Policy Values as at the Effective Date. I consider this to be reasonable given that, as noted above, it is ELAS's established practice to apply any distribution of working capital in proportion to Policy Values and the proportions of total Policy Values represented by Transferring Policies and Remaining Policies are not expected to change materially over the next 20 years.

7.51 The allocation of working capital to Transferring Policies will not however be the full amount of the allocation based on an apportionment by Policy Values. This is because, as is described in Section 5, it is proposed that there will be various reallocations between the Transferring Policies and Remaining Policies in order to, for example, allow for ELAS's view of a fair allocation of the costs of the transaction and to compensate the Remaining Policies for diseconomies of scale. Part of the allocation of working capital to the Transferring Policies will also be used to fund part of the Mortality Premium (see paragraphs 7.60 to 7.63) and to meet part of the cost of the Up-front Guarantee Charge (see paragraphs 7.64 to 7.67). These amounts are being allocated to the WPSF of PAC and are not therefore available for distribution to the Transferring Policies.

7.52 In aggregate, based on the pro-forma figures presented in Sections 5 and 6, had the Effective Date been 31 December 2006, while an allocation of working capital to the Transferring Policies based on Policy Values would have represented around 12% of their Policy Values, the amount allocated to the asset shares of the Transferring Policies would have been a little under 4% of the Policy Values of the Transferring Policies. In considering the impact of the Scheme on the Transferring Policies, the cost represented by the difference between these two figures (i.e. around 8% of Policy Values) must be weighed up against the positive impacts of the Scheme on Transferring Policies. I consider this in paragraph 7.72.

7.53 It is also important to appreciate that the amount of working capital allocated to the asset shares of Transferring Policies as at the Effective Date could differ materially from the 4% of Policy Values determined based on pro-forma figures as at 31 December 2006, and could even be negative. The actual allocation will depend on:

- the level of working capital in ELAS as at the Effective Date;
- the proportion of working capital allocated by ELAS to the Transferring Policies as at the Effective Date; and
- the size of the Mortality Premium and the Up-front Guarantee Charge to the extent that it reduces the amount of working capital available to be allocated to the asset shares of Transferring Policies.

7.54 Factors that could adversely affect the size of the uplift include, in particular, poor investment performance in 2007. ELAS has estimated that a reduction in working capital of around £200 million from the position at 31 December 2006 might eliminate any uplift completely. By way of illustration, it has been estimated that this might occur if, over 2007, there was a fall in the value of property investments held by ELAS of around 20% or a combination of a fall in the value of property investments held by ELAS of around 10% and an increase in the annual yield on fixed interest investments held by ELAS of around 1 percentage point. Of course, in these scenarios, there would also be an adverse impact on ELAS's ability to make distributions from its working capital in the absence of the Scheme.

7.55 Other factors that could adversely affect the size of the uplift include any unforeseen costs arising, or requiring a provision to be established, in 2007 that have not already been provided for in determining the estimate of the WPA Allocated Amount. These might include, for example, costs arising from negotiations with HBOS over the size of any break fee payable to HBOS for the loss of the contract to administer the Transferring Policies.

Timing of distribution of working capital

7.56 ELAS has estimated that, in the absence of unforeseen costs, and assuming future experience in line with current best estimate assumptions, its working capital would be

sufficient to fund additions to Policy Values for AWP policies, and enhancements to non-guaranteed income on with-profits annuities, of around 2% per annum for the lifetime of those policies. However, in practice, ELAS is constrained by other factors. In particular, the timing of the distribution has to have regard to the need for ELAS to continue to meet its contractual obligations as they fall due and the need to maintain an appropriate level of capital. Consequently in the short term, any distributions of working capital are expected to be at a lower rate than the 2% per annum referred to above. The non-guaranteed bonus announced by ELAS for 2006 included an addition of around 1% in respect of a distribution of working capital. To the extent that distributions of working capital are lower in the short term, reflecting the holding back of capital, future distributions should be higher. However, the level of these future distributions is subject to significant uncertainty arising from the possibility of unforeseen costs, or the possibility that foreseen costs turn out to be different from those expected.

7.57 On implementation of the Scheme, to the extent that the allocation of ELAS's working capital to PAC exceeds, or falls short of, that required to fund the Mortality Premium and Up-front Guarantee Charge, it will be allocated to the asset shares of Transferring Policies. If there is a positive allocation to asset shares, it will result in an immediate uplift to non-guaranteed income around 6 to 9 months after the Effective Date. If there is a negative allocation to asset shares, PAC may choose to either reflect this immediately in a reduction in non-guaranteed income or reduce future levels of non-guaranteed bonus.

7.58 Although any allocation of working capital to the asset shares of Transferring Policies as at the Effective Date will be less than the amount of working capital attributable to the Transferring Policies immediately before the Effective Date any such immediate allocation will be a benefit to the holders of Transferring Policies in that it will reduce uncertainty over them receiving it. This is because any working capital allocated to the asset shares of the Transferring Policies will no longer be exposed to the risks that the working capital in ELAS is exposed to, including expense risk, all risks in respect of ELAS's other business and, with the limited exception referred to in paragraph 4.10, liabilities arising from acts or omissions of ELAS (e.g. mis-selling liabilities) in respect of the Transferring Policies since these will remain in ELAS. The Scheme also requires that the asset shares of the Transferring Policies shall have no exposure to profits and losses arising from PAC's other policies, experience or business activities.

7.59 Had the Effective Date been 31 December 2006, as noted above, based on pro-forma figures, there would have been an allocation of working capital to the asset shares of Transferring Policies equal to a little under 4% of the Policy Values in respect of Transferring Policies as determined by ELAS. As explained in paragraph 7.34, this would have resulted in an uplift to non-guaranteed income of around 3.5%. However, as noted in 7.53, the actual allocation of working capital, and hence uplift to non-

guaranteed income, could turn out to be materially higher or lower than this and could be negative.

Determination of the Mortality Premium

7.60 The Mortality Premium represents compensation funded by the Transferring Policies and Remaining Policies for the benefit, provided by the WPSF, of the cap and floor on the impact of future mortality experience.

7.61 Although, if the possibility of a need to strengthen or weaken the initial mortality assumptions is considered equally likely, one could argue that the expected cost to the WPSF is nil (i.e. it is as likely to make a profit as it is to make a loss), some compensation to the WPSF is still appropriate given the risk that that Sub-Fund is taking on and the capital it will need to hold in respect of that risk. Also, I have already noted in paragraph 7.43 that I believe that the reduction in uncertainty resulting from the cap and floor is a positive feature for the holders of Transferring Policies.

7.62 The Mortality Premium will be £17 million adjusted for the change in the amount of Aggregate Initial Asset Shares between the date as at which this premium was determined and the Effective Date.

7.63 Given the significant level of uncertainty regarding the level of future annuitant mortality, it is very difficult to judge the appropriate premium. I understand that the Mortality Premium is the result of a negotiation between ELAS and PAC, although it also reflects a calculation by PAC based on an estimate of the theoretical cost plus an additional loading to allow for uncertainty around the expected mortality experience for the Transferring Policies and the cost of capital. I have considered this calculation and consider the basis adopted to be fair as between the holders of policies in ELAS and the holders of policies in PAC.

Determination of the Up-front Guarantee Charge

7.64 The WPA Allocated Amount includes an amount in respect of the excess of the "future cost of guarantees" on Transferring Policies over the "value of the planned deductions for the cost of guarantees" on Transferring Policies. This is determined using the same methodology as used by ELAS in the preparation of its published realistic balance sheet. As at 31 December 2006, this amount was £11 million.

7.65 While the Up-front Guarantee Charge is determined using a similar methodology, it has been determined, on a pro-forma basis, as at 31 December 2006, as £43 million. The excess over the £11million referred to in the previous paragraph (i.e. around £32 million based on calculations as at 31 December 2006) will be funded from the allocation of working capital to the Transferring Policies.

7.66 The principal reason for the additional cost of guarantees is that the higher equity backing ratio in the WPSF of PAC leads to an increase in the time value cost of the guarantees. Effectively, the Up-front Guarantee Cost represents part of the cost being borne by the holders of the Transferring Policies for the greater investment freedom and potential for higher investment returns that they will enjoy after the Effective Date. Generally accepted views are that in the long-term holding equity type investments is likely to lead to higher investment returns than investment in fixed interest securities or cash.

7.67 The actual calculation of the Up-front Guarantee Charge includes a number of adjustments reflecting differences between figures calculated using ELAS's model and PAC's model. These adjustments do not affect my conclusions that the Up-front Guarantee Charge, including these adjustments, is reasonable and fair as between the holders of Transferring Policies and the WPSF.

Smoothing

7.68 While ELAS has a preference that changes in levels of bonuses should be gradual, its ability to smooth bonuses in adverse scenarios is limited by its financial position.

7.69 After the implementation of the Scheme, any short-term costs of smoothing the level of non-guaranteed income on Transferring Policies will be funded by the WPSF of PAC. The strength of this Fund means that it is more able to fund the costs of smoothing than ELAS. This is a benefit to the holders of Transferring Policies particularly given the greater volatility of investment returns they might experience as a result of the higher equity backing ratio.

7.70 While the WPSF will fund any short-term costs of smoothing, it should be noted that ultimately it will be the Transferring Policies that meet the cost of smoothing since the Transferring Policies Smoothing Account (see paragraphs 4.28 to 4.30) is to be managed with the aim that it should tend to zero. As the number of Transferring Policies in-force reduces, the burden of eliminating any negative balance or the benefit of sharing any positive balance on the Transferring Policies Smoothing Account will also fall on a smaller group of policies.

7.71 There are provisions in the Scheme which require PAC, in normal circumstances, to smooth within bounds set out in the Scheme (see paragraph 4.30). The lower bound is equivalent to attributing a minimum of zero investment return, net of charges, to Transferring Policies. PAC is however permitted to smooth outside these bounds in certain circumstances; for example, following a significant fall or rise in market values (either sudden or over a period of years). Such a situation arose in February 2003, when PAC reduced payout values on its own with-profits business below the lower bound of its normal smoothing limits. The Actuarial Function Holder of PAC has also noted that the requirement to manage the Transferring policies Smoothing Account

with the on-going aim that it should tend to zero may lead to a degree of smoothing applied to Transferring Policies which is different to that applied to business in the WPSF. It is common practice when managing with-profits business to permit smoothing outside of normal bounds in exceptional circumstances in order to protect other with-profits policies and I therefore believe that the inclusion of these provisions in the Scheme is reasonable.

Summary and conclusions with regard to reasonable expectations

7.72 In my view, it is appropriate when considering the implications of the Scheme for the reasonable benefit expectations of holders of Transferring Policies to consider the impact of the Scheme overall and not to focus on individual factors. The implications of the Scheme on the benefit expectations of the holders of Transferring Policies can be summarised as follows:

Determination of income payable

- The level of the income payable under a Transferring Policy will be determined as the maximum of the guaranteed and non-guaranteed income applicable to the policy. This is the current position in ELAS and will continue to be the position following the transfer to PAC.

Guaranteed income

- Each Transferring Policy will have the same level of guaranteed income immediately following the Effective Date as it had immediately before the Effective Date.
- After the Effective Date, PAC will determine the level of any guaranteed bonuses. I understand that PAC considers it unlikely that it will declare any such bonuses in the foreseeable future but this is no different to the current position in ELAS.

Non-guaranteed income

- Each Transferring Policy will also have the same level of non-guaranteed income immediately following the Effective Date as it had immediately before the Effective Date.
- As is the case in ELAS, the development of non-guaranteed income will reflect investment return net of charges and be impacted by changes in actual and assumed future mortality experience.
- In the absence of the Scheme, Transferring Policies could also expect to benefit over time from the distribution of a share of the working capital of ELAS. Such distribution would however be likely to be delayed and subject to the risk that unforeseen costs might diminish the amount of the working capital available for distribution.
- If the Scheme is implemented, Transferring Policies may receive a positive adjustment to the level of their non-guaranteed income from a date expected to be

around 6 to 9 months after the Effective Date. Any such positive adjustment would represent a one-off distribution to Transferring Policies of a part of their share of the working capital of ELAS. This would be a benefit since any such distribution would no longer be subject to the uncertainties associated with the distribution of working capital in ELAS. Reliance cannot however be placed on there being a positive adjustment to non-guaranteed income as a result of the Scheme since this will depend on a number of factors as at the Effective Date (see paragraph 7.53). Indeed, it is possible that there could be a negative adjustment to Transferring Policies' asset shares and a subsequent reduction in non-guaranteed income.

- Based on pro-forma figures as at 31 December 2006, had the Effective Date been 31 December 2006, there would have been a one-off positive adjustment to non-guaranteed income of around 3.5%. Transferring Policies would not then however have benefited from any further distributions of working capital after the Effective Date. By way of comparison, in the absence of the Scheme, had ELAS made a one off distribution of working capital of 3.5% as at 31 December 2006, ELAS has estimated that it might have been able to continue to make future distributions of working capital equivalent to around 1.75% per annum. This figure should be treated as illustrative only especially since, in practice, any such distributions would most likely be delayed and subject to the uncertainty arising from the risks referred to above. Nevertheless, in considering the impact of the Scheme on the Transferring Policies, it is useful to compare this indicative measure of the future distributions of working capital foregone as a result of the implementation of the Scheme with the positive impacts of the Scheme on Transferring Policies described below.

- The most significant difference for Transferring Policies arising from the Scheme is the mix of assets backing their policies. The equity backing ratio is expected to increase from under 20% to around 70%. In the longer term, it is generally considered that investment in equities and property will provide higher investment returns than investment in fixed interest securities and cash, albeit at the expense of greater volatility and the risk of falls in values. Given the additional 50% of assets invested in equities and property, it might be assumed that in order to compensate the Transferring Policies for the 1.75% per annum distributions of working capital foregone, it will be necessary for the additional equity and property investments held to outperform the investment return on fixed interest securities and cash by 3.5% per annum. This however ignores the impact of guarantees and the volatility of investment returns, which is discussed below. Having regard to these factors, the mean outperformance over the return on fixed interest investments and cash required from the additional investment in equities and property is significantly less than 3.5% per annum.

- In practice, the extra equity and property investments held after implementation of the Scheme could result in significantly higher or significantly lower investment

returns. (The distributions of working capital in ELAS in the absence of the Scheme could also be different to the 1.75% per annum figure referred to above.) Consequently the non-guaranteed income on Transferring Policies could be significantly higher or lower as a result of implementation of the Scheme. However, whereas the potential upside for policyholders is unlimited, the downside is limited by the guarantees under the policies, which will be unaltered by the Scheme. Transferring Policies will also have no further exposure to the cost of these guarantees since this will be met by the WPSF of PAC.

- Many Transferring Policies (in particular, around 80% of Transferring Policies with a 3.5% GIR as at 31 December 2006) have a level of non-guaranteed income which is less than their guaranteed income. Many other Transferring Policies (including both Transferring Policies with a GIR of 3.5% and those with a GIR of 0%) have non-guaranteed income which is not significantly higher than their guaranteed income. Consequently, many Transferring Policies, which could benefit significantly from potential outperformance of equity investments, have limited exposure to potential underperformance.

- As at 31 December 2006, there were relatively few Transferring Policies where the non-guaranteed income exceeded the guaranteed income by in excess of 10%. Compared to those policyholders mentioned above, these Transferring Policies have a greater downside risk of potential falls in income payable in the event of adverse investment performance by equities and property. However, they will still benefit from the increased potential for improved investment performance. Such policies will also enjoy the other benefits arising from the implementation of the Scheme described below.

- Transferring Policies will benefit from greater certainty over the level of charges that they will incur for expenses and the cost of guarantees, both of which are capped by the Scheme but currently uncapped in ELAS. The impact of changes in the assumed level of future mortality on the level of non-guaranteed income will also be limited broadly to a reduction or increase in annual non-guaranteed income equivalent to a deduction from, or an addition to, asset shares of 0.5% per annum (although within these bounds, Transferring Policies will be affected more than they would have been in ELAS because in ELAS, the Remaining policies share the impact). The premium for this reduction in mortality risk is around 1% of the Policy Values of Transferring Policies, which is an indication of the value of this benefit to the Transferring Policies.

- Transferring Policies can also expect some protection from short term fluctuations in asset values because the Scheme requires that, in normal circumstances, changes in non-guaranteed bonus rates will be smoothed such that the non-guaranteed income will not fully reflect falls in investment returns. The degree of smoothing is not however guaranteed and while the WPSF of PAC will fund any short-term

costs of smoothing, it is intended that the remaining Transferring Policies will ultimately meet the full cost of smoothing.

Overall implications for Transferring Policies

- It is clear from the foregoing that, for Transferring Policies, the Scheme will give rise to benefit expectations which are different to those applying in ELAS currently. This is primarily a reflection of the significantly greater exposure to equity-type investments following implementation of the Scheme compared to the position currently. This greater level of exposure is similar to that which the holders of Transferring Policies may have expected when effecting their policies.
- While the Scheme may result in future benefits payable on Transferring Policies which are similar to those which would have applied in the absence of the Scheme, it may also result in future benefits which are either materially greater than or materially less than those which would have applied in the absence of the Scheme. Whereas the potential upside is unlimited, the downside is limited by the guarantees under the policies, which will be unaltered by the Scheme. Considering the portfolio of Transferring Policies as a whole, it is my view that the reasonable benefit expectations of the holders of Transferring Policies in aggregate will not be adversely affected by the Scheme.

Administration and level of service

7.73 PAC is experienced in administering its own portfolio of with-profits annuities and other companies in the Prudential group have experience of accepting and integrating transfers of blocks of non-profit annuity business. Consequently, I believe that holders of Transferring Policies can expect the administration of their policies and the quality of service they receive to be at an appropriate level after the transfer.

7.74 I understand that PAC is considering outsourcing some of the administration relating to a small number (less than 1000) of Transferring Policies where the benefits are denominated in a currency other than sterling. I have been advised by PAC that, should this outsourcing take place, PAC will put in place the necessary requirements to ensure these policyholders receive equivalent levels of service to other policyholders.

7.75 Where applicable, annuity payments are made to policyholders net of tax deducted on behalf of HM Revenue and Customs ("HMRC"). I understand that, because the way PAC administers multiple policies for the same policyholder is different to the way such policies are currently administered by ELAS, it will be necessary for HMRC to issue PAC with new tax codes for the policies concerned. Around 6,700 policyholders may be affected and, for some of these policyholders, there may be an increase in the tax deducted from annuity payments made until such time as HMRC issue PAC with new tax codes. I understand that any over deductions of tax will be automatically corrected once the new tax codes are in place. Other than rounding (which I understand will always be carried out in the direction to benefit the holders of the

Transferring Policies, the gross amount of the annuity payments (before deduction of tax) will be unaffected.

Tax

7.76 I understand that applications for tax clearances have been made to HMRC and are expected to be received. The proposed Scheme will not proceed unless tax clearances satisfactory to both ELAS and PAC are received in advance of the Effective Date. These include confirmation from HM Revenue & Customs that the tax status of the holders of Transferring Policies and of any pension scheme to which the Transferring Policies are or were issued will not be adversely affected by the Scheme.

7.77 I understand that PAC and ELAS have satisfied themselves that the implementation of the proposed Scheme, from a tax point of view, should not adversely affect their respective policyholders' benefit expectations.

Amendment to terms and relaxation of Scheme

7.78 At any time after the sanction of the Scheme, PAC and ELAS may apply to the Court for consent to amend the terms of the Scheme provided that the Insurance Regulator is notified and has the right to be heard by the Court and an independent actuary certifies that in his opinion the proposed amendment will not adversely affect the fair treatment of the holders of Transferring Policies.

7.79 The Scheme however also provides that in certain circumstances and at any time after 2009, certain of the terms on which PAC will be permitted to manage the Transferring Policies may be amended without further application to the Court or a certificate from an independent actuary. Certain of the provisions of the Scheme cannot be changed in this way (see paragraph 4.69). For those that can be changed (for example, those in respect of smoothing), I am satisfied that the relaxed protections afforded, namely approval of the PAC With Profits Committee and advance notification to the FSA, together with a requirement that the Principles of Financial Management are not changed to the material detriment of the Transferring Policies are reasonable from the point of view of the Transferring Policies.

7.80 Given the protections afforded, I also consider that the terms allowing for a relaxation of the Scheme after the realistic liabilities have fallen below an amount equal to £100 million (increased by the increase in the retail prices index) are reasonable from the point of view of the Transferring Policies.

Excluded Policies

7.81 As noted in paragraph 4.61, any Excluded Policies will be retained by ELAS but reinsured on terms such that the benefits payable under such policies will be identical to the benefits which would have been payable had the Excluded Policies been

transferred to PAC under the terms of the Scheme. Consequently, the comments in this section on the benefit expectations of holders of Transferring Policies apply equally to holders of Excluded Policies.

7.82 So far as security of guaranteed benefits is concerned, holders of Excluded Policies, if any, will need to continue to look to ELAS since ELAS, although it will benefit from the reinsurance with PAC, will be responsible for benefit payments to holders of Excluded Policies. The comments on security of guaranteed benefits for holders of Remaining Policies in the next section are therefore relevant to holders of Excluded Policies.

PPFM

7.83 Under FSA rules, PAC is required to maintain and publish Principles and Practices of Financial Management ("PPFM") in respect of its with-profit funds. These PPFM will have to be modified to reflect the inclusion of the Transferring Policies and will need to be consistent with the Principles of Financial Management in the Scheme. As at the date of this report, PAC had not finalised the proposed amendments to its PPFM. However, I understand that the proposed amendments will be consistent with the description of how it is intended to manage the Transferring Policies contained in this report.

Membership Rights

7.84 Membership of ELAS is discussed in paragraphs 2.3 to 2.7. If the Scheme is implemented, those holders of Transferring Policies that were members of ELAS will lose their membership rights in ELAS and will not be entitled to equivalent rights in PAC. Other than the loss of the right to attend, take part in and vote in general meetings, I am not aware of any material benefits attributable to the holders of Transferring Policies as members in the normal course that will be lost as a result of the implementation of the Scheme.

7.85 By ceasing to be members of ELAS, the holders of Transferring Policies will also no longer be liable for the debts of ELAS arising from ELAS being an unlimited company (see paragraph 2.7).

Parliamentary Ombudsman's report

7.86 There is currently an ongoing investigation by the Parliamentary Ombudsman into the conduct of the former regulators of ELAS. The European Parliament has also reported on the regulation of ELAS. I understand that some holders of Transferring Policies might be concerned that, should the publication of these reports lead to compensation being payable to ELAS policyholders by the British Government, they might forego any entitlement to receive such compensation as a result of the Transfer of their policies from ELAS to PAC. It is outside my area of expertise to comment on the likelihood of there being any such compensation payable, the basis on which any such compensation would be paid and hence on whether the implementation of the Scheme could impact on the interests of holders of Transferring Policies in this respect.

Summary of conclusions

7.87 To summarise:

- For Transferring Policies, the Scheme will give rise to benefit expectations which are different to those applying in ELAS currently. This is primarily a reflection of the significantly greater exposure to equity-type investments following implementation of the Scheme compared to the position currently . This greater level of exposure is similar to that which the holders of Transferring Policies may have expected when effecting their policies.
- While the Scheme may result in future benefits payable on Transferring Policies which are similar to those which would have applied in the absence of the Scheme, it may also result in future benefits which are either materially greater than or materially less than those which would have applied in the absence of the Scheme. Whereas the potential upside is unlimited, the downside is limited by the guarantees under the policies, which will be unaltered by the Scheme. Considering the portfolio of Transferring Policies as a whole, it is my view that the reasonable benefit expectations of the holders of Transferring Policies in aggregate will not expected to be adversely affected by the Scheme.
- It is my view that the security of the Transferring Policies' guaranteed benefits will be enhanced by the Scheme.

8 Implications for the holders of policies remaining in ELAS

8.1 In this section of my report, I consider the likely effects of the proposed Scheme on the holders of policies remaining in ELAS (the "Remaining Policies"). In particular, I consider:

- the security of policyholders' benefits; and
- policyholders' reasonable benefit expectations.

Security of policyholders' benefits

8.2 The proposed Scheme removes the significant longevity risk associated with the with-profits annuity policies from the holders of the Remaining Policies. This is likely to be beneficial from the point of view of the security (and benefit expectations) of the remaining with-profits policyholders.

8.3 However, the Proposed Scheme also results in a proportionately greater exposure to operational risks since most of the existing operational risks (including those in relation to the Transferring Policies arising from acts or omissions of ELAS that occurred on or before the Effective Date) will remain with ELAS.

8.4 An example of an operational risk is that there is currently an ongoing investigation by the Parliamentary Ombudsman into the conduct of the former regulators of ELAS. The European Parliament has also reported on the regulation of ELAS. While I understand that ELAS does not expect any claims against it to arise as a result of the publication of these reports and that ELAS believes that the risk of any successful claims being brought in this regard is low, if there were any successful claims, they would fall to be met from the assets attributable to a smaller group of policyholders.

8.5 Section 5 of this report considers the financial position of ELAS before and after implementation of the Scheme. In particular, Tables 5.4 and 5.5 illustrated, on a pro-forma basis, the estimated impact of the Scheme on the regulatory balance sheet and the realistic balance sheet of ELAS had the transfer occurred at 31 December 2006. These Tables are summarised in Tables 8.1 and 8.2 below.

Table 8.1: Impact of Scheme on the regulatory balance sheet of ELAS as at 31/12/06

	Before Scheme(*) (£m)	**Change (£m)**	**After Scheme(*) (£m)**
Regulatory value of assets	10,085	(1,854)	8,231
Regulatory value of liabilities	(9,069)	1,425	(7,644)
Regulatory capital available	**1,016**	**(429)**	**587**
as % of regulatory value of liabilities	11.2%		7.7%

Note to Table 8.1:

(1) All figures in this Table are adjusted for certain post balance sheet events as discussed in paragraph 5.2.

Table 8.2: Impact of Scheme on the realistic balance sheet of ELAS as at 31/12/06

	Before Scheme(*) (£m)	**Change (£m)**	**After Scheme(*) (£m)**
Realistic value of assets backing WP business	9,428	(1,854)	7,574
Realistic value of with-profits liabilities	(8,532)	(1,625)	(6,907)
Working capital (excess of assets over liabilities)	**896**	**(229)**	**667**
as a % of realistic value of liabilities	10.5%		9.7%

Notes to Table 8.2:

(1) All figures in this Table are adjusted for certain post balance sheet events as discussed in paragraph 5.3.

(2) The excess of assets over liabilities will be distributed amongst the holders of with-profits policies over the lifetime of the policies. Hence the realistic balance sheet for the ELAS published in ELAS's returns to the FSA show the excess of assets over liabilities as part of the realistic liabilities under the heading "Planned enhancements to asset shares".

8.6 The proposed Scheme results in an overall reduction in working capital. This is because a proportion of the working capital is transferred to PAC with the Transferring Policies. When expressed as a percentage of the realistic value of with-profits liabilities, however, the working capital reduces only slightly from 10.5% to 9.7% as a result of the proposed Scheme.

8.7 On a regulatory peak basis, which is an indication of the ability to meet guaranteed benefits, the excess of assets over liabilities reduces from 11.2% to 7.7%. This suggests a diminution in security. However, it is appropriate to also consider ELAS's individual assessment of its capital requirements (the "ICA"), which takes account of the actual risks to which ELAS is exposed.

8.8 As noted in Section 5 (see paragraphs 5.29 to 5.30), ELAS has produced calculations that demonstrate that ELAS has sufficient capital to meet its ICA capital requirement both before and after implementation of the Scheme. There is however a reduction in

the excess of available cover over the ICA capital requirement which is an indication that, as at the Effective Date, there will be a diminution in security for the Remaining Policies.

8.9 The ICA capital requirement represents ELAS's assessment of the capital required to ensure that there is no significant risk that ELAS's liabilities cannot be met as they fall due. Given that ELAS is closed to new business, to the extent that it has any material working capital in excess of its ICA capital requirement, it is likely to distribute this capital to its with-profits policyholders. The reasonable expectations of policyholders are therefore that on an ICA basis, ELAS is only ever likely to maintain a small level of cover over its ICA capital requirements.

8.10 On the basis of the above analysis, it is my view that the security of the guaranteed benefits of holders of Remaining Policies can be expected to remain at an acceptable level following implementation of the Scheme.

Policyholders' benefit expectations

8.11 The terms and conditions of all Remaining Policies (other than Excluded Policies, which will be amended as described in paragraph 4.61) will be unaltered as a result of implementation of the Scheme.

8.12 There is no impact of the Scheme on the benefit expectations of non-profit policyholders.

8.13 The benefit expectations of the remaining with-profit policyholders are impacted by the allocation of working capital between the Transferring Policies and Remaining Policies. This is described in Section 5. I consider the approach proposed to be adopted for dividing the working capital to be reasonable and fair from the point of view of the Remaining Policies. In particular, I note that the proposed approach includes an adjustment which aims to ensure that the expense charges made on the Remaining Policies after implementation of the Scheme are no higher than they would have been in the absence of the Scheme. (This is the adjustment described in Section 5 as "an adjustment to compensate the Remaining Policies for diseconomies of scale".)

8.14 Although there is a small reduction in working capital as a percentage of with-profit policyholders' asset shares, ELAS considers it likely that it will be able to distribute the working capital more quickly as a result of the implementation of the Scheme. This is because the average outstanding duration of the Transferring Policies is greater than the average outstanding duration of the Remaining Policies and capital that might, in the absence of the Scheme, have had to be retained within ELAS beyond the lifetime of many of the Remaining Policies might be available for distribution to these Remaining Policies. This is likely to be beneficial to some of the Remaining Policies.

8.15 Based on the above analysis, it is my view that there will be no material adverse impact of the Scheme on the reasonable benefit expectations of the holders of Remaining Policies.

Strategic options

8.16 The Proposed Scheme results in a simplification of the underlying business within ELAS, which means potentially greater flexibility for ELAS with regards to possible future strategic options that might be undertaken for the benefit of the with-profits policyholders of Remaining Policies.

Summary of conclusions

8.17 To summarise, it is my view that there will be no material adverse impact of the Scheme on the reasonable benefit expectations of the holders of Remaining Policies and that the security of the guaranteed benefits under these policies will remain at an acceptable level following implementation of the Scheme.

9 Implications for the existing holders of policies in PAC

9.1 In this section of my report, I consider the likely effects of the proposed Scheme on the PAC policyholders. In particular, I consider:

- the security of policyholders' benefits; and
- policyholders' reasonable benefit expectations.

Impact of the Scheme on PAC

9.2 First, I summarise the impact of the Scheme on each of the WPSF, NPSF, DCPSF and SAIF.

With-Profits Sub-Fund (WPSF)

9.3 The Scheme will impact primarily on the WPSF. This Fund will:

- meet the cost of guarantees in respect of Transferring Policies in return for receiving the Up-front Guarantee Charge and on-going charges of up to 0.5% per annum of the asset shares of Transferring Policies;
- provide the "cap and floor" protection to the Transferring Policies in respect of changes in mortality assumptions (see paragraphs 4.32 to 4.36) in return for receiving the Mortality Premium;
- receive any mortality profits and meet any mortality losses (expected to be neutral in aggregate over time) resulting from mortality experience different to that assumed in setting non-guaranteed income levels on Transferring Policies;
- provide capital to support the Transferring Policies in the DCPSF and the additional risks taken on in the WPSF in return for a contribution received from the shareholders of PAC via the NPSF; and
- benefit from, or meet the burden of, any adjustments required between the WPSF and DCPSF on the Adjustment Payment Date (see paragraph 4.55).

Non Profit Sub-Fund (NPSF)

9.4 The NPSF will be entitled to receive charges equal to 1% per annum of the asset shares of the Transferring Policies as compensation for meeting all expenses of administering the Transferring Policies and the associated risks.

9.5 I understand that PAC believes that the charges received by the NPSF will be sufficient to cover both the costs of administering the Transferring Policies and the cost of compensating the WPSF for providing capital to support the risks it is taking on in respect of the Transferring Policies (see paragraphs 6.17 and 6.18). There should therefore be no adverse impact on the security or benefit expectations of any PAC policyholder as a result of this element of the Scheme.

Defined Charge Participating Sub-fund (DCPSF)

9.6 The DCPSF will hold the asset shares of the Transferring Policies. It is a requirement of the Scheme that these asset shares will be maintained separately from the asset shares of all other PAC policies.

9.7 The Transferring Policies' asset shares will be credited with investment return and debited with charges and non-guaranteed income before smoothing (based on the expected rather than actual mortality) on the Policies. To the extent that actual income payments differ from the expected payments (whether that be as a result of mortality experience different to that assumed, guaranteed income exceeding the non-guaranteed income before smoothing or smoothing), the difference will be met by the WPSF.

9.8 Given the above and the fact that non-guaranteed income (before smoothing) will be set so as to extinguish the asset shares of the Transferring Policies over the lifetime of the Transferring Policies, no miscellaneous profits or losses can arise in the DCPSF as a result of the proposed Scheme. The Scheme therefore has no impact on benefit expectations of existing PAC policies allocated to the DCPSF.

Scottish Amicable Insurance Fund (SAIF)

9.9 The Scheme has no direct impact on the SAIF or, therefore, on the benefit expectations of policies allocated to the SAIF.

Impact on PAC policyholders

9.10 It is evident from the above summary of the impact of the Scheme on PAC that the only policyholders of PAC where their benefit expectations might be affected in any material way by the Scheme is the WPSF.

9.11 The security of guaranteed benefits of all PAC policyholders might also be impacted in extremis by the impacts on the WPSF because this Fund provides capital support to each of the NPSF, DCPSF and SAIF.

9.12 In considering the implications for PAC policyholders, I therefore concentrate in this Section on the impacts of the Scheme on the WPSF.

Policyholders' benefit expectations for policies allocated to the WPSF

9.13 I understand that PAC intends that any profits or losses arising in the WPSF in respect of the support provided to the Transferring Policies will accrue to the inherited estate in that fund and not be reflected in the asset shares of policies contained in that fund. There is not therefore expected to be any direct impact arising from the Scheme on any existing policyholders in the WPSF (or, in any other sub-fund of PAC's long-term insurance fund).

9.14 There could however be an indirect impact on holders of policies in the WPSF if the estate in the WPSF was reduced in size as a result of losses arising in respect of the Transferring Policies and this impacted on the investment freedom of the fund and the security provided by the estate. This outcome is however considered to be unlikely.

Security of benefits

9.15 The financial impact of the Scheme on the WPSF is considered in Section 6 (see paragraphs 6.9 to 6.18).

9.16 On the basis used by PAC to determine its realistic balance sheet, after taking account of the Up-front Guarantee Charge and the planned charges for guarantees, the cost of the guarantees on the Transferring Policies is expected to give rise to a small cost to the WPSF on a market consistent basis. This was assessed as at 31 December 2006 as £13 million. The actual cost or benefit to the WPSF in respect of the cost of, and charges for, the guarantees on Transferring Policies could of course be quite different to this. Given the size of this relative to the size of the working capital of the WPSF at 31 December 2006 (£8,619 million), I do not consider that there is any material impact on policyholders.

9.17 As at the Effective Date, on the basis used by PAC to determine its realistic balance sheet, the cap and floor protection provided to the Transferring Policies in respect of changes to the mortality assumptions used to determine non-guaranteed income is expected to represent neither an asset nor a liability and the receipt of the Mortality Premium would therefore increase the working capital of the WPSF by £18 million.

9.18 There is significant uncertainty over future levels of annuitant mortality. Assumptions ("central estimates" as at 31 December 2006) have been made about the future level of mortality improvements. The WPSF will incur a cost if future improvements in mortality are materially greater than these central estimates and benefit if future improvements in mortality are materially less than this central estimate. The Actuarial Function Holder and With-Profits Actuary of PAC have both opined that they consider the Mortality Premium to be a fair premium for the risk taken on by the WPSF. I concur with this view.

9.19 As noted in Section 6, other impacts of the Scheme on the WPSF are expected to be neutral over time.

9.20 The net impact of the above on the realistic balance sheet of the WPSF was illustrated, on a pro-forma basis, in Table 6.6 in Section 6. This is summarised in Table 9.1 below.

Table 9.1: WPSF - Impact of the Scheme on the realistic balance sheet as at 31/12/06

	Before Scheme (£m)	Change (£m)	After Scheme (£m)
Realistic value of assets backing WP business	**76,942**	**61**	**77,003**
Realistic value of with-profits liabilities	**(68,322)**	**(56)**	**(68,378)**
Working capital (excess of assets over liabilities)	**8,619**	**5**	**8,624**
Risk Capital Margin	(1,818)	(165)	(1,983)
Surplus assets	**6,801**	**(160)**	**6,641**
as % of realistic value of liabilities	10.0%		9.7%

9.21 It can be seen that the Scheme is expected to have little net impact on the working capital (excess of assets over liabilities) of the WPSF. There is however a material increase in the Risk Capital Margin (a minimum capital requirement of the Fund) reflecting the risks being taken by the Fund.

9.22 As discussed in paragraphs 6.17 and 6.18, to compensate the WPSF for providing the capital to cover these risks, PAC will make payments from the NPSF (i.e. at the cost of shareholders) equal to 0.14% per annum of asset shares, based on the estimated cost of providing such support in relation to the assessed ICA capital requirements.

Summary of conclusions

9.23 In summary, it is my view that:

- the security of guaranteed benefits of existing PAC policyholders will not be materially affected by the Scheme; and
- there will be no adverse impact of the Scheme on the reasonable benefit expectations of PAC policyholders.

10 Summary of conclusions

10.1 Based on my analysis of the impact of the Scheme on the various groups of policyholders affected in both ELAS and PAC contained in this report, my conclusions can be summarised as follows.

- For Transferring Policies, the Scheme will give rise to benefit expectations which are different to those applying in ELAS currently. This is primarily a reflection of the significantly greater exposure to equity-type investments following implementation of the Scheme compared to the position currently. This greater level of exposure is similar to that which the holders of Transferring Policies may have expected when effecting their policies.
- While the Scheme may result in future benefits payable on Transferring Policies which are similar to those which would have applied in the absence of the Scheme, it may also result in future benefits which are either materially greater than or materially less than those which would have applied in the absence of the Scheme. Whereas the potential upside is unlimited, the downside is limited by the guarantees under the policies, which will be unaltered by the Scheme. Considering the portfolio of Transferring Policies as a whole, it is my view that the reasonable benefit expectations of the holders of Transferring Policies in aggregate will not be adversely affected by the Scheme.
- It is my view that the security of the Transferring Policies' guaranteed benefits will be enhanced by the Scheme.
- It is my view that there will be no material adverse impact of the Scheme on the reasonable benefit expectations of the holders of policies remaining in ELAS and that the security of the guaranteed benefits under these policies will remain at an acceptable level following implementation of the Scheme.
- It is my view that there will be no adverse impact of the Scheme on the reasonable benefit expectations of PAC policyholders and that the security of guaranteed benefits of these policyholders will not be materially affected by the Scheme.

10.2 Based on the above conclusions, I consider that the impact of the implementation of the Scheme on the various groups of policyholders affected in both ELAS and PAC is consistent with those policyholders being treated fairly.

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