PHOENIX GROUP

ABBEY LIFE ASSURANCE COMPANY LIMITED

Proposed Scheme to transfer the entire business of Abbey Life Assurance Company Limited to Phoenix Life Limited

Report by the With-Profits Actuary on the impact of the Scheme on With-Profits Policyholders of Abbey Life Assurance Company Limited

11 July 2018

1. INTRODUCTION

The purpose of this report is to give my opinion on the effect of a proposed scheme under Part VII of the Financial Services and Markets Act 2000 (the "Scheme") on the with-profits policyholders of Abbey Life Assurance Company Limited ("Abbey Life"). Under the Scheme, the entire business of Abbey Life is to transfer to Phoenix Life Limited ("Phoenix").

Under the Scheme, it is proposed that all the business in the two with-profits funds of Abbey Life will be converted to non-profit polices with guaranteed future additions and transferred to the Non-Profit Fund of Phoenix. The assets of the with-profits funds will be transferred to the NPF of Phoenix. This report describes how the Scheme is expected to affect the with-profits policyholders of Abbey Life.

This report is written for the Abbey Life Board and With-Profits Committee ("WPC") in my capacity as With Profits Actuary for Abbey Life. As well as the Abbey Life Board and WPC, this report has been made available to the independent expert, the PRA and the FCA in connection with forming their own judgements about the Scheme and it will be provided to the High Court so that it can be taken into account when the High Court reaches its decision on whether or not to approve the Scheme.

In preparing this report I have considered the Scheme document and the report by the Chief Actuary of Abbey Life on the impact of the Scheme on the policyholders of Abbey Life (the "Abbey Life CA Report"). Section 3 of that report gives details of the structure and history of Abbey Life and section 4 provides details of the Scheme and such details are therefore not repeated in this report. Terms defined in that report carry the same meanings in this report unless otherwise specified.

I have taken into consideration the Principles and Practices of Financial Management ("PPFM") of Abbey Life, which apply to the with-profits funds of Abbey Life before implementation of the Scheme.

This report and the underlying preparation work that has been carried out is in my opinion compliant with the relevant Technical Actuarial Standards issued by the Financial Reporting Council that apply to certain types of actuarial work, namely TAS100: Principles for Actuarial Work and TAS 200: Insurance.

In my opinion there has been an appropriate level of review in the production of this report and that it is compliant with the requirements of Actuarial Practice Standard X2 as issued by the Institute and Faculty of Actuaries.

2. BACKGROUND

I am a Fellow of the Institute of Actuaries. I was appointed as With Profits Actuary for Abbey Life on 3 November 2017.

I also act as With Profits Actuary for the Britannic With-Profits Fund and the Britannic Industrial Branch Fund of Phoenix.

I am an employee of Pearl Group Services Limited ("PGS"), which is a wholly owned subsidiary of the ultimate parent company of Abbey Life, Phoenix Group Holdings. I hold two low-cost endowment policies with another group company, Phoenix Life Assurance Limited, but I am not a policyholder of any of the other companies within the Phoenix Group, including Abbey Life. I currently have options on a number of Phoenix Group Holdings shares.

I confirm that I have not considered my personal interest in reaching any of the conclusions detailed in this report.

3. MAIN EFFECTS OF THE SCHEME

3.1. Policies in the Hill Samuel Participating Business Fund ("Hill Samuel PB Fund")

As part of the Scheme, it is proposed that the with-profits policyholders in the Hill Samuel PB Fund are converted to a non-profit guaranteed bonus basis and transferred to the Phoenix NPF. The assets of the Hill Samuel PB Fund will also be transferred to the NPF.

Background

The business in the Hill Samuel PB Fund comprises conventional with-profit whole of life and endowment assurances (including policies with guaranteed minimum surrender terms referred to as "Flexiplan" policies) that were sold between 1966 and 1987. There were 1,220 with-profits policies in-force at the end of 2017.

The following table shows the remaining policies by product as the end of 2017:

Hill Samuel PB Fund Products	Policies	Premium paying	Paid Up	Reserves (£k)
Flexiplan endowment	558	421	137	4,498
Traditional endowment	4	4	0	70
Traditional Whole life	658	470	188	29,782
Total	**1,220**	**895**	**325**	**34,351**

The Hill Samuel Scheme that transferred the business from Hill Samuel to Abbey Life in 1998 included a provision amending the terms of the policies that are now within the Hill Samuel PB Fund to include a 'sunset clause' allowing those policies to be converted to non-profit when fewer than 1,000 policies remain (although there is no obligation for Abbey Life to do so when this point is reached). Based on maturities and the run-off of policies, it is expected that the number of policies will fall below 1,000 in 2019, which would permit the sunset clause to be triggered at that time.

The fund has been preparing for the conversion to non-profit around 2019 for some time. It has reduced the exposure to property and equity assets – currently less than 5% of the fund is held in equities and property and the remaining holdings are due to be sold before the end of 2018 – and been managed such that no estate arises in the fund. Any surplus/deficit arising each year is reflected in final bonus rate increases/reductions.

All policies in the fund share the same final bonus and annual bonus scales, meaning there are cross subsidies between the Flexiplans/endowments and the whole of life policies. This position was reviewed by the Abbey Life Board in December 2013 and the following approach was adopted in 2014:

- A single annual bonus rate and scale of final bonus rates would continue to be paid for all policies.

- To improve the fairness of distributions between policies with different maturity dates, annual bonuses would be reduced to 0.5%.
- To ensure future pay-outs are sustainable, the final bonus scale would be reduced for all types of policies. To ensure that the reasonable expectations of policyholders maturing relatively soon are not breached, this reduction would be smoothed over a number of years. Reductions would be sufficient so that a stable sustainable position would be reached by the expected date of conversion to non-profit.
- The final bonus scale would be further reduced, but to a lesser extent, in each year after the anticipated conversion date, to reflect that investment returns have been lower in recent years.

The final bonus scale has been managed in line with the above approach with final bonus rates reducing in future, but at a lower rate from 2020 onwards (i.e. a last "larger" reduction in the 2019 declaration).

In preparation for the closure of the fund, Abbey Life has been investigating and attempting to reduce the number of policyholder for whom it does not hold an up-to-date address. This activity will continue until the end of 2018. However, it is recognised that, because of the quality of information held and the length of time policies have been in force, Abbey Life may not be able to establish an address for all these policyholders, which could mean that no claim is received on these policies. If a claim is not received, it is a potential source of surplus and it is proposed to recognise this in the payment of a special bonus as described below.

Proposal

It is proposed that following implementation of the Scheme the 0.5% annual bonus becomes guaranteed at that rate and the future pattern of final bonus rates is calculated and fixed.

The levels of these guaranteed final bonuses will be calculated based on the number of policies in force and economic and other factors as at the Transfer Date of the Scheme. Therefore, the bonuses are not known at the date of this report. Based on the method and basis that I will follow (see below) and economic conditions as at 31 December 2017, indicative rates of guaranteed bonuses are shown in Appendix 1.

The method and assumptions that I will use to determine these bonuses as at the Transfer Date of the Scheme will be as follows:

Assumptions:

- Future Investment Returns – To be based on the expected future returns of the assets in the fund at the Transfer Date. It is anticipated that the current programme of disinvestment from equities and property will be completed by the end of 2018.
- Expenses – continuation of expenses currently charged to the fund, which are lower than the actual costs of running the fund, with the maintenance expenses increasing at best estimate of future expense inflation.
- Mortality – current assumptions.
- Surrenders – No allowance.
- Shareholder Transfer – 10% of guaranteed bonuses.

Method: produce a final bonus scale varying by term for each future year that:

- Maintains the level of pay-out after the transfer date as illustrated in Appendix 1 table (c).
- Produces a zero surplus, excluding any potential surplus from policyholders who are not expected to claim.
- Results in guaranteed benefits that are fair for endowments and Flexiplan policies by ensuring the guaranteed maturity proceeds meet the PPFM requirement to target not less than 90% of projected asset shares.

A special bonus will also be calculated and declared at the Transfer Date of the Scheme based on the policyholders' share of the potential future surplus from policyholders who are not expected to claim. This will be determined separately for each with-profits fund using the methodology outlined in Appendix 3. The special bonus will be added by increasing the guaranteed benefits of each policy by a fixed percentage so as to use up all the potential future surplus attributable to policyholders.

Once the special bonus is declared the shareholder will lose or gain from whether more or fewer claims are made by policyholders than allowed for in this calculation. I believe that the allocation of this potential surplus is fair to with-profits policyholders.

The surrender value calculation is different for the three product types, but all are variations of the sum assured and annual bonus plus the final bonus applicable at date of surrender, with adjustments for outstanding term or unpaid premiums. The Flexiplan surrender basis does not include any discounting, so there is not currently any discretionary element to the surrender basis, therefore the basis can continue as-is after conversion.

The surrender value basis will be fixed and continue to reflect the fair value on policies including special and final bonus at the Transfer Date. The basis will be determined using the same assumptions as those used to calculate the final bonus. If a policy surrenders post conversion, the fair value will be calculated using the basis above but discounted using the discount rate at the time of surrender.

Fairness

The proposed conversion approach for policies within the Hill Samuel PB Fund is consistent with the provisions of the sunset clause that applies to the policies and the policies will continue to operate in much the same way as before conversion, but with certainty over the maturity and death benefits of their policies.

The working assumption has been that the sunset clause will be triggered and policies converted to non-profit during 2019 utilising the sunset clause. Undertaking the conversion to a non-profit guaranteed bonus basis as part of the Scheme will benefit policyholders. The terms of the conversion are subject to external review and scrutiny by the Independent Expert and regulators and will be approved by the High Court, and the Part VII process also gives policyholders the opportunity to raise any concerns that they have directly with the High Court.

The ability to close a with-profits fund in this way is a useful tool in ensuring that policyholders are treated fairly, both in terms of the expenses they are charged and the way surplus in the fund can be distributed when a with-profits fund has significantly run-off, by spreading any remaining surplus over the remaining policyholders and avoiding a tontine. The fund currently benefits from low expenses as it is not charged any project costs or a share of overhead costs, and is charged significantly lower investment expenses than those being incurred. These costs could increase in future if the shareholder no longer wished to continue this subsidy but the guaranteed bonuses remove this risk.

Overall, I believe that the proposals are fair to policyholders in the Hill Samuel PB Fund. The guaranteed bonus proposals are designed to ensure a fair distribution of the surplus assets for different generations of policyholders. Policyholders should not lose their qualifying status as a result of the changes and an indemnity is included in the Scheme such that policyholders will not suffer should they become liable to additional tax as a result of these proposals. I am thus satisfied that the proposed transfer of Hill Samuel PB Fund policies will not adversely affect the reasonable expectations of Hill Samuel PB Fund policyholders.

3.2. Policies in the Abbey Life Participating Business Fund ("Abbey Life PB Fund")

As part of the Scheme, it is proposed that the with-profits policyholders in the Abbey Life PB Fund are converted to a non-profit guaranteed bonus basis and transferred to the Phoenix NPF. The assets of the Abbey Life PB Fund will also be transferred to the NPF.

Background

The business in the Abbey Life PB Fund consists mainly of Planned Investment Endowment policies ("PIE" policies). These are unit-linked policies with a small with-profits element. There are also a very few whole life and endowment conventional with-profits ("CWP") policies, and two unit-linked pension Investment Annuity Contract ("IAC") policies. The policies were all sold between 1965 and 1973. As at the end of 2017 there were 89 policies in-force, although the last PIE policy still has nearly 20 years until it matures.

The following table shows the remaining policies by product as the end of 2017:

Abbey Life PB Fund Products	Policies	Premium paying	Paid Up	Reserves (£k)
PIE	80	36	44	930
IAC	2	0	2	26
CWP endowment	1	1	0	11
CWP whole life	6	2	4	35
Total	**89**	**39**	**50**	**1,002**

Although the policy numbers are low, contact rates are also low. A detailed tracing exercise is underway for the other policies to find and verify an address where this is not held. This activity will continue until the end of 2018.

In recent years the fund has been managed to try to ensure that no estate is retained. Any surplus/deficit arising each year is reflected in increases/reductions in the PIE final bonus rates and hence paid away.

In practice it is only the PIE product that participates in the fund profits; the IAC contracts are both past retirement age, which means that no further bonuses are being added and the CWP policies receive annual bonuses only which have been stable for many years and the PPFM states these are "expected to remain at current levels without change" so policyholder expectations are that the annual bonus amount will not change.

As with the Hill Samuel PB Fund, it is recognised that, because of the quality of information held and the length of time policies have been in force, Abbey Life may not be able to establish an address for all the policyholders in the Abbey Life PB Fund, which could mean that no claim is received on these policies. If a claim is not received from a policyholder, it is a potential source of surplus and it is proposed to recognise this in the payment of a special bonus as described below.

Planned Investment Endowments

The PIE polices are unit-linked policies with a small with-profits element written between 1965 and 1972. Premiums buy distribution units either in unit trusts or OEICs.

Currently final bonus rates are declared each year based on the dividend income from distribution units in the fund and any surplus arising in the fund. All changes in surplus in the fund over the year are reflected in the PIE final bonus.

Annual bonuses are being declared and have remained unchanged since 1996.

It is proposed that the current annual bonus rates continue as now and become guaranteed and that the final bonus as at the transfer date is calculated as normal, but to eliminate all the surplus in the fund (ignoring any potential surplus from policyholders who are not expected to claim).

In future, "non-profit" final bonus rates will be calculated each year based only on the distribution received from the underlying unit trust or OEIC. For the avoidance of doubt the shareholder will not be entitled to any part of the assets supporting the non-profit final bonus. The non-profit final bonus process will not involve the exercise of discretion or allow for any other sources of surplus.

The non-profit final bonus rate for a given policy will then be combined with the final bonus rate calculated at the transfer date to give the total final bonus.

The method and assumptions that I will use to determine the final bonus rate to apply as at the transfer date will be as follows:

Assumptions:

- Future Investment Returns – best estimate based on the asset held to back the liabilities.
- Expenses – continuation of expenses currently charged to the fund, which are lower than the actual costs of running the fund, with the maintenance expenses increasing at best estimate of future expense inflation.
- Mortality – current assumptions.
- Surrenders – best estimate assumption of 1% per annum.
- Shareholder Transfer – 10% of bonuses.

Method:

- Calculate the surplus in the fund as at the Transfer Date based on guaranteed annual bonus rates.

- Adjust the final bonus rate as required in order to produce a zero surplus, excluding any potential surplus from policyholders who are not expected to claim.

The surrender values for PIE policies are the bid value of units, plus reversionary bonuses added plus the current final bonus less a deduction for capital gains tax. As there is no discounting in the basis the surrender value calculations can continue unaffected post conversion.

Investment Annuity Contract

The IAC polices are unit-linked pension policies with a small conventional with-profits element. Only 2 IAC policies remain and one is expected to claim during 2018.

Both policies have passed their "Normal Retirement Date", consequently the annual and final bonuses, which will apply on claim, are now fixed and they are not participating in any future surplus arising in the fund. No changes are proposed for these policies.

Conventional endowment and whole life

There are only a very small number of CWP polices remaining: 1 endowment and 6 whole life.

A final bonus has never been declared for these policies and it is clearly stated in the PPFM that this position will continue. Despite the guarantees being in the money policyholders are receiving a small annual bonus, which has been stable for many years. There are no expectations that this annual bonus will change in future, as is stated in the PPFM.

Given the above, the conversion proposal for these policies is simply to continue with the current level of annual bonus.

The surrender value for these policies is the sum assured plus annual bonuses with a deduction for any premiums that will not be received. This approach would be expected to continue after conversion unchanged.

Therefore for these policies there will be no real difference in relation to annual and final bonuses other than certainty that annual bonuses will remain unchanged for the remaining term of the policies.

Special Bonus

A special bonus will also be calculated and declared at the Transfer Date of the Scheme based on the policyholders' share of the potential future surplus from policyholders who are not expected to claim. This will be paid on both PIE and conventional policies. It will be determined separately for each with-profits fund using the methodology outlined in Appendix 3. The special bonus will be added by increasing the guaranteed benefits of each policy by a fixed percentage so as to use up all the potential future surplus attributable to policyholders.

Once the special bonus is declared the shareholder will lose or gain from whether more or fewer claims are made by policyholders than allowed for in this calculation. I believe that the allocation of this potential surplus is fair to with-profits policyholders.

Fairness

The proposed conversion approach for Abbey Life PB Fund means policies will continue to operate in much the same way as before conversion, but with certainty over the benefits of their policies and certainty that expenses will not increase. The expenses charged to the fund are very small and the fund is currently being subsidised by the Abbey Life Non-Profit Fund. These costs could increase in future if the shareholder no longer wished to continue this subsidy, but converting to non-profit removes this risk.

The fund does not have a sunset clause so converting the policies to non-profit as part of the Part VII Scheme is a practical way to closing what is already an extremely small with-profits fund in the final stages of run-off, and of distributing the remaining surplus in the fund fairly.

Overall, I believe that the proposals are fair to policyholders in the Abbey Life PB Fund. Policyholders should not lose their qualifying status as a result of the changes and an indemnity is included in the Scheme such that policyholders will not suffer should they become liable to additional tax as a result of these proposals. I am thus satisfied that the proposed transfer of Abbey Life PB Fund policies would not adversely affect the reasonable expectations of Abbey Life PB Fund policyholders.

4. OTHER IMPLICATIONS OF THE SCHEME

4.1. Policyholder Security

For the reasons given in section 6.1 of the Abbey Life CA Report, overall I am satisfied that the Scheme does not have a material adverse effect on the security of the Abbey Life with-profits policyholders. In particular:

- although the Solvency Ratio would be less in Phoenix after the Scheme than it is in Abbey Life, for the reasons given in the Abbey Life CA Report this will not have a material effect on the security of the benefits of the transferring Abbey Life policyholders after the Scheme is implemented; and
- as there are only small differences in approach between Phoenix and Abbey Life in calculating their technical provisions and SCR and in operating their respective capital policies and these will not have a material effect on the security of the benefits of the current Abbey Life with-profits policyholders after the Scheme is implemented.

4.2. Quality of Administration

The terms upon which administration services for with-profits policies are currently provided to Abbey Life by Capita will continue to apply in respect of the business in Abbey Life following the Scheme. Therefore, there is no reason to expect the quality of administration or the level of service provided to Abbey Life policyholders to deteriorate as a consequence of the Scheme.

4.3. Notification to Policyholders

I have reviewed the mailing packs prepared for Abbey Life with-profits policyholders, which include the Scheme guide and the separate flyer for with-profits policyholders, and the related materials to be made available on the Abbey Life website. I am satisfied that the information regarding the proposals as contained therein adequately describes the proposals for with-profits policyholders.

5. CONCLUSION

In my opinion as With-Profits Actuary, taking into account the opinions set out above, no class of Abbey Life with-profits policyholder will be materially adversely affected by the implementation of the Scheme. In particular, I believe that the Scheme should not have any adverse impact on the security of benefits or benefit expectations of the Abbey Life with-profits policyholders

Kevin Arnott

K J Arnott
Fellow of the Institute of Actuaries
11 July 2018

Appendix 1

Indicative Final Bonus for policies within the Hill Samuel Participating Fund

The final bonus rates are expressed as a percentage of the total amount of annual bonuses added to a policy, which increases over time. The final bonus rates change on 1 April each year, at the same point where annual bonuses are added.

Tables (a) and (b) below set out the indicative final bonus percentages expected to apply in future. These are indicative only as they will not be confirmed until the surplus in the fund at the Transfer Date is known. Once confirmed, these final bonus rates will be guaranteed.

The rates will apply to all current with-profits policies in the fund. The indicative total pay-outs that are expected to apply from conversion, excluding any element of special bonus are shown in table (c).

Note that tables (b) and (c) show the progression of final bonus rates and payouts over time for a policy sold in the years shown in each row. In future years the final bonus in table (b) decrease each year offsetting the annual bonus being added. This results in the level payouts shown in table (c).

(a) Indicative final bonus ("FB") rates for varying durations in force.
The scale reduces by 3.9% per year on 1 April from 2019 onwards.

Duration in force at maturity	Current FB % 2018	Indicative FB %			
		Date of transfer to 31 March 2019	1 April 2019 to 31 March 2020	1 April 2020 to 31 March 2021	1 April 2021 to 31 March 2022
30	15.7%	15.7%	10.4%	6.5%	2.6%
35	30.2%	30.2%	24.9 %	21.0%	17.1%
40	44.7%	44.7%	39.4%	35.5%	31.6%

(b) Indicative final bonus rates for varying years of entry.
The scale reduces by 1.0% per year on 1 April from 2019 onwards.

Entry Year	Current FB % 2018	Indicative FB %			
		Date of transfer to 31 March 2019	1 April 2019 to 31 March 2020	1 April 2020 to 31 March 2021	1 April 2021 to 31 March 2022
1985	24.4%	24.4%	22.0%	21.0%	20.0%
1980	38.9%	38.9%	36.5%	35.5%	34.5%
1975	53.4%	53.4%	51.0%	50.0%	49.0%

(c) The projected pay-outs per £1,000 sum assured based on the above indicative final bonus rates and the guaranteed annual bonus rates of 0.5%. The pay-outs are expected to be reasonably stable over time.

Entry Year	Current payout per £1,000 sum assured 2018	Indicative pay-out per £1,000 sum assured			
		Date of transfer to 31 March 2019	1 April 2019 to 31 March 2020	1 April 2020 to 31 March 2021	1 April 2021 to 31 March 2022
1985	3,080	3,080	3,060	3,060	3,060
1980	4,180	4,180	4,150	4,150	4,150
1975	5,560	5,560	5,520	5,520	5,520

These figures exclude any element of special bonus declared on conversion. Any special bonus will apply from the Transfer Date.

Appendix 2

Future Final Bonus for policies within the Abbey Life Participating Fund

Conventional With-Profits Policies in the fund do not receive a final bonus and this will continue after conversion.

Remaining Investment Annuity Contracts have already received their final bonus when they reached their nominated retirement date.

The final bonus rate for Planned Investment Endowment policies will continue to change based on the dividend income from the underlying investments each year.

Appendix 3

Derivation of Policyholders' share of the potential future surplus from policyholders who are not expected to claim

It is proposed to identify the reserves for policyholders for whom as at the Transfer Date Abbey Life does not hold a verified address and allocate part of this to pay a special bonus to all policyholders at such date. Note that policyholder liabilities will always be met in full even by Phoenix if for the purposes of calculating this bonus it is assumed that no claim will be made.

Untraced category	Rationale	Proposed allocation
Policies that could not be traced, ie a potential address could not be identified, due to poor or missing data	It is difficult to make a judgement on these policies so in the absence of further data assume that only half the policies will claim.	50% policyholder
Overseas policyholders, who do not respond to our mailing	Having written to those we have addresses for, we assume that half of the policies where no reply is received will not claim	50% policyholder
Potential address identified but no contact has been established and Records are held with some data but not enough to confirm identity of policyholder at an address	Policies in this category are assigned a likelihood of contact from "platinum" to "bronze" based on a number of criteria. For those in the lowest class (bronze), it is assumed that no claim will be made. Whilst for the others it is assumed that a claim will be made.	Bronze status 100% policyholder