



Report of the Independent Expert on the proposed transfer of certain legacy business from Royal & Sun Alliance Insurance PLC and from The Marine Insurance Company Limited to Mercantile Indemnity Company Limited

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1. PURPOSE AND SCOPE

PURPOSE OF THIS REPORT

- 1.1 It is proposed that particular blocks of business of Royal & Sun Alliance Insurance plc (“RSAI”) and of The Marine Insurance Company Limited (“MIC”) be transferred to Mercantile Indemnity Company Limited (“Mercantile”) by an insurance business transfer scheme (“the Scheme”), as defined in Section 105 of the Financial Services and Markets Act 2000 (“FSMA”). Together, RSAI and MIC are the “Transferors” and Mercantile is the “Transferee”.
- 1.2 Section 109 of FSMA requires that an application to the High Court of Justice in England and Wales (“the Court”) for an order sanctioning an insurance business transfer scheme must be accompanied by a report on the terms of the transfer (“the FSMA Report”) by an independent person (“the Independent Expert”) having the skills necessary to make the report and who is nominated or approved by the Prudential Regulation Authority (“PRA”), having consulted with the Financial Conduct Authority (“FCA”). The FSMA Report is required in order that the Court may properly assess the impact of the proposed transfer, including the effect on the policyholders of the insurance companies in question.
- 1.3 RSAI, MIC and Mercantile have collectively nominated me to act as Independent Expert to provide the FSMA Report in respect of the Scheme, and the PRA has approved my appointment in consultation with the FCA (see paragraph 1.20 below).
- 1.4 This report (the “Report”) describes the proposed transfer and discusses its possible effects on the policyholders of Mercantile, MIC and RSAI (in respect of all business of Mercantile, MIC and RSAI), including its effects on the security of policyholder benefits and levels of service. As such, this Report fulfils the requirements of the FSMA Report.
- 1.5 RSAI, MIC and Mercantile are domiciled, authorised and regulated in the UK.
- 1.6 RSAI is an indirect subsidiary of RSA Insurance Group plc (“RSAIG”) and MIC is a subsidiary of RSAI. Mercantile is an indirect subsidiary of Enstar Group Limited (“EGL”). In this Report, I refer to EGL and its direct and indirect subsidiaries collectively as “the Enstar Group” and to RSAIG and its direct and indirect subsidiaries collectively as “the RSA Group”.
- 1.7 A list of terms defined in this Report is shown in Appendix A. Otherwise I use the same defined terms (which are capitalised in this Report) as are in the document that sets out the terms of the Scheme (the “Transfer Document”).

THE PROPOSED SCHEME

- 1.8 The business to be transferred under the Scheme (“the Transferring Business”) comprises defined portfolios of business underwritten by RSAI and by MIC (or by other entities, the business being subsequently transferred to RSAI or MIC) mostly prior to 2006. The Transferring Business comprises most of the managed portfolio within RSAI and MIC of legacy insurance business, i.e. lines of business that are no longer considered core to RSAI or to MIC, or that have been in run-off for a protracted period. I discuss the Transferring Business in more detail in paragraphs 4.133 - 4.143 below.
- 1.9 The business to be transferred from MIC (“the MIC Transferring Business”) is currently wholly reinsured by RSAI.
- 1.10 As a precursor to the Scheme, on 7 February 2017, RSAI, MIC and Mercantile¹ entered into a Business Transfer Agreement (“the BTA”) whereby RSAI and MIC agreed to transfer to Mercantile, and Mercantile agreed to accept from RSAI and MIC, the Transferring Business, and to effect this by means of an insurance business transfer scheme pursuant to Part VII of FSMA (a “Part VII Transfer”).

1 The BTA was initially between RSAI, MIC and Belmont Run-off Limited (“Belmont”), another member of the Enstar Group, The Enstar Group subsequently decided that the Transferee should be Mercantile and the BTA was then novated, by an agreement dated 27 April 2017, from Belmont to Mercantile. In this Report, I have ignored the original involvement of Belmont as I do not consider it relevant to my analysis of the Scheme and its effects, and I do not discuss Belmont any further.

- 1.11 Moreover, it was agreed that the economic risk and reward associated with the Transferring Business should be transferred to a reinsurer within the Enstar Group. Accordingly, RSAI and Fitzwilliam Insurance Limited (“Fitzwilliam”), a member of the Enstar Group, acting in respect of its segregated account Number 38, entered into a reinsurance agreement (“the Reinsurance Agreement”) whereby, with effect from 23:59 hours on 31 December 2016, the business to be transferred from RSAI (“the RSAI Transferring Business”), plus RSAI’s 100% reinsurance of the MIC Transferring Business, was wholly reinsured by Fitzwilliam. This was intended to be a temporary arrangement until Cavello Bay Reinsurance Limited (“Cavello Bay”), another member of the Enstar Group, received approval from the Bermuda Monetary Authority to enter into the Reinsurance Agreement, which would then be novated from Fitzwilliam to Cavello Bay. That approval has been granted, the novation has occurred and the RSAI Transferring Business, together with RSAI’s 100% reinsurance of the MIC Transferring Business, is currently 100% reinsured by Cavello Bay.
- 1.12 No part of the insurance liabilities of RSAI or MIC other than that relating to the Transferring Business will be transferred under the Scheme.
- 1.13 Together, the RSAI Transferring Business and the MIC Transferring Business comprise the entire Transferring Business.
- 1.14 The assets to be transferred to Mercantile under the Scheme (“the Transferring Assets”) include all outwards reinsurance contracts that relate to the Transferring Business (or, in respect of any reinsurance contract that covers both policies within the Transferring Business and policies that will remain with the Transferor(s) post the Effective Date, such rights and obligations under that contract that relate to the Transferring Business), including the Reinsurance Agreement. However, by a Deed of Amendment, the terms of the Reinsurance Agreement will be amended on and with effect from the Effective Date such that, post-Scheme, Mercantile will be 75% reinsured by Cavello Bay in respect of the Transferring Business.
- 1.15 The reinsurance agreements currently in place between RSAI and MIC will be amended if so needed to reflect the Scheme, but will not be terminated completely or transferred as part of the Scheme, as they also cover other business written by, or transferred to, MIC that will remain in MIC post-Scheme.
- 1.16 The operational management of the Transferring Business, including all policy administration, claims handling, etc., is currently conducted by RSAI; in respect of the MIC Transferring Business, this is in accordance with an outsourcing agreement between MIC and RSAI. The BTA includes a list of RSAI employees who are wholly or mainly engaged in claims handling and management of the Transferring Business (the “Assumed Employees”). The Assumed Employees will be transferred to the Enstar Group entity that, post-Scheme, will be assuming, on behalf of Mercantile and under an outsourcing agreement, the management and claims handling of the Transferring Business with effect from the Effective Date. The Assumed Employees include staff drawn from claims operations, actuarial and finance. The list of Assumed Employees will be updated closer to the Effective Date. I discuss this further in Section 4 below.
- 1.17 The Effective Date of the Scheme is expected to be 1 July 2019.
- 1.18 Pre-Scheme, Mercantile has no policyholders.
- 1.19 The business involved in the Scheme, the arrangements for the Scheme and the effect of the Scheme are discussed in more detail in Sections 4 to 8 of this Report.

THE INDEPENDENT EXPERT

- 1.20 I, Derek Newton, have been appointed by RSAI, MIC and Mercantile as the Independent Expert to consider the Scheme under Section 109 of FSMA. My appointment has been approved by the PRA in consultation with the FCA; this was confirmed in a letter dated 6 June 2017.

- 1.21 I am a Principal of Milliman LLP (“Milliman”) and I am based in its UK General Insurance practice in London. I am a Fellow of the Institute and Faculty of Actuaries, which was established in 2010 by the merger of the Institute of Actuaries and the Faculty of Actuaries. I became a Fellow of the Institute of Actuaries in 1988. My experience of general insurance includes (reserved) roles as Signing Actuary to Lloyd’s syndicates and to Irish non-life insurance companies, as well as acting as the Independent Expert in four insurance business transfer schemes that were sanctioned in 2014, 2015, 2016 and 2017 respectively. I have included my Curriculum Vitae in Appendix D in which I explicitly note the insurance business transfer schemes in which I have acted as the Independent Expert, as well as those for which I have provided peer review support to the Independent Expert.
- 1.22 I do not have, and have never had, any policies issued by any part of the RSA Group or the Enstar Group. I am not a shareholder of either RSAIG or EGL. I was the Independent Expert reporting on the transfer of a small block of run-off business (the “Tower Pool business”) from RSAI to Knapton Insurance Limited, which is a member of the Enstar Group – that transfer was approved by the Court in October 2015. I also peer reviewed the work of Gary Wells, who is also a Principal of Milliman LLP, when he acted as Independent Expert in respect of three interlinked Part VII transfer schemes and a separate Part VII transfer scheme, all involving the RSA Group (see paragraph 1.23 below for details). I have undertaken no other work for any part of either the RSA Group or the Enstar Group. I note that Milliman is part of a global consulting business, the parent company of which is Milliman, Inc. I refer to Milliman, Inc. and its direct and indirect subsidiaries collectively as “the Milliman Group”. Individual practices within the Milliman Group have worked with parts of the RSA Group and the Enstar Group on assignments in other countries.
- 1.23 The overall fee income that Milliman has received from the RSA Group worldwide in any of the last seven years (2011 to 2017) has averaged 0.04%, and has not exceeded 0.16%, of Milliman’s corresponding annual global revenue. The main assignments carried out for the RSA Group worldwide over the last six years were as follows:
- Gary Wells was the Independent Expert for the transfer of businesses from PA(GI) Limited to RSAI and to MIC. I was peer reviewer to the project. The transfers were approved by the Court on 12 December 2011.
 - Gary Wells was the Independent Expert for the transfer of the businesses of 22 UK regulated entities to 5 UK companies (all transferees and transferors were members of the RSA Group) via 3 Part VII transfer schemes. I was peer reviewer to the project. The transfers were approved by the Court on 12 December 2011.
 - As noted above, I was the Independent Expert reporting on the transfer of the Tower Pool business from RSAI to Knapton Insurance Limited.
 - Gary Wells was the Independent Expert for the transfer of the Italian branch businesses of the RSA Group to ITAS Mutua. I had no involvement in this project. The transfers were approved by the Court on 27 October 2015.
 - Gary Wells was engaged as the Independent Actuary for the transfer of the business of the Irish subsidiary of the RSA Group to the Irish branch of RSAI. I had no involvement in this project. This project was abandoned in June 2016 following the referendum vote for the UK to leave the EU.
 - Milliman provides annual claim reserving and pension advice to the Global Aviation Pool, of which the British Aviation Insurance Company Limited (“BAIC”) had a share (although none since 2001). BAIC is 57% owned by RSA Group. Over the last six years, I have had no involvement with BAIC.
- 1.24 The overall fee income that Milliman has received from the Enstar Group worldwide in any of the last six years (2011 to 2017) has averaged 0.03%, and has not exceeded 0.08%, of Milliman’s corresponding annual global revenue. The main assignments carried out for the Enstar Group worldwide over the last six years were as follows:
- As mentioned above, I was the Independent Expert reporting on the transfer of the Tower Pool business from RSAI to Knapton Insurance Limited.
 - Gary Wells acted as the Independent Actuary for the transfer of the UK branch insurance business of Nisshin Fire & Marine Insurance Company Limited to Rombalds Run-off Limited. The Court sanctioned this transfer in December 2017. Rombalds Run-off Limited is a member of the Enstar Group, which shares, in Kenmare Holdings Ltd, a common parent with Mercantile and Cavello Bay but which is otherwise unrelated to them. I was not involved in this project.

- Milliman offices based in the USA:
 - Assisted the Enstar Group on reserve reviews for some of the workers compensation pools that the Enstar Group manages and some of the pools to which the Enstar Group has exposure; and
 - Conducted a review of EGL in 2015 on behalf of a prospective investor.
- A Milliman consultant based in Dublin has been the Appointed Actuary to Laguna Life Limited for several years and has assisted the Enstar Group with some M&A work related to life assurance.
- During 2017, Milliman was engaged to design and build spreadsheet models that the Enstar Group can use to project future cash flows relating to US asbestos claims for each of its largest accounts. Milliman's involvement in this project is purely software development. While it is expected that these models might be used by the Enstar Group in future reserving work, Milliman does not anticipate any involvement in reserving work for the Enstar Group. I have not been involved in this project.

- 1.25 I do not believe that the involvement of other consultants within the Milliman Group with the RSA Group or the Enstar Group affects my ability to act independently in my assessment of the Scheme.
- 1.26 The Scheme is subject to sanction by the Court under Section 111 of FSMA.
- 1.27 RSAI and MIC on the one hand and Mercantile on the other hand will share the costs of my work as Independent Expert. No costs of the Scheme will be borne by any of the policyholders of any of RSAI, MIC and Mercantile.

THE SCOPE OF MY REPORT

- 1.28 My terms of reference have been reviewed by the PRA and by the FCA and are set out in Appendix E.
- 1.29 I have considered the terms of the Scheme only and have not considered whether any other scheme or alternative arrangement might provide a more efficient or effective outcome.
- 1.30 The Report describes the Scheme and the likely effects on policyholders of RSAI, MIC and Mercantile, including effects on the security of policyholders' benefits and levels of service.
- 1.31 The Report should be read in conjunction with the full terms of the Scheme.
- 1.32 My work has required an assessment of the liabilities of RSAI, MIC, Mercantile and Cavello Bay for the purposes of describing the effect of the Scheme. My review of the liabilities was based on the actuarial reserve assessments conducted by internal actuaries of the RSA Group, on behalf of RSAI and MIC, and of the Enstar Group, on behalf of Mercantile and Cavello Bay. I have reviewed the methodology and assumptions used in their work and have assessed the key areas of uncertainty in relation to these liabilities. I have not attempted to review in detail the calculations performed by the internal actuaries of the RSA Group or the Enstar Group or to produce independent estimates of the liabilities.
- 1.33 In addition to the liabilities, I have assessed the appropriateness in nature and amount of any assets to be transferred under the Scheme, and the capital position of RSAI, MIC, Mercantile and Cavello Bay pre- and post-Scheme. Again, I have not attempted to review in detail the calculations of the capital position performed by the internal actuaries of the RSA Group in respect of RSAI and MIC, or by the internal actuaries of the Enstar Group in respect of Mercantile or Cavello Bay, and I have not attempted to produce independently my own estimates.
- 1.34 As far as I am aware, there are no matters that I have not taken into account in undertaking my assessment of the Scheme and in preparing this Report, but which nonetheless should be drawn to the attention of policyholders in their consideration of the Scheme.
- 1.35 In reporting on the Scheme as the Independent Expert, I recognise that I owe a duty to the Court to assist the Court on matters within my expertise. This duty overrides any obligation to RSAI, to MIC and / or to Mercantile. I confirm that I have complied with this duty.

- 1.36 I am aware of the requirements regarding experts set out in Part 35 of the Civil Procedure Rules, Practice Direction 35 and the Protocol for Instruction of Experts to give Evidence in Civil Claims.
- 1.37 I confirm that I have made clear which facts and matters referred to in this Report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.
- 1.38 Shortly before the date of the Court hearing at which an order sanctioning the Scheme will be sought, I will prepare a supplementary report (“the Supplementary Report”) covering any relevant matters that might have arisen since the date of this Report.
- 1.39 It is intended that both this Report and the Supplementary Report will be published on a dedicated website, and that copies of this Report and the Supplementary Report will be sent to anyone who requests them. The Report will be made available in this way immediately following the directions hearing relating to the Scheme (or as soon thereafter that the dedicated website has been set up) and the Supplementary Report will likewise be made available before the date of the Court hearing.

Materiality

- 1.40 After considering the effects of the Scheme on each of the different groups of policyholders affected by the Scheme (as identified in paragraph 5.20 below), I have drawn conclusions as to whether I believe the Scheme will materially adversely affect that group of policyholders. It should be recognised that the Scheme will affect different policyholders in different ways, and, for any one group of policyholders, there may be some effects of the Scheme that are positive, and others that are adverse. If some effects of the Scheme are adverse, that does not necessarily mean that the Scheme is unreasonable or unfair, as those adverse effects may be insignificant or they may be outweighed by positive effects.
- 1.41 In order to determine whether any effects of the Scheme on any group of policyholders are *materially* adverse, it has been necessary for me to exercise my professional judgement in the light of the information that I have reviewed.
- 1.42 When assessing the financial security of policyholders, I have looked at the solvency position of the companies involved in the Scheme, on both pre- and post-transfer bases, relative to regulatory solvency requirements, and also at the nature of the assets that constitute each company’s capital and surplus. It should be noted that a company may have capital considerably in excess of its regulatory requirements, but that the directors of a company could legitimately reduce that level of capital (for example through the payment of dividends) and still leave the company appropriately capitalised. In circumstances where the Scheme has adversely affected the financial security of a group of policyholders, in order to determine whether that impact is material, I have considered whether the level of financial security projected to be in place after the transfer would have been acceptable and permissible before the transfer had taken place. I would determine that any adverse impact to a particular group of policyholders is material if the level of financial security afforded to them after the transfer would not have been acceptable under the normal constraints under which the company’s capital position was managed before the transfer.

THE STRUCTURE OF MY REPORT

- 1.43 The remainder of this Report is set out as follows:
- Section 2: I provide an executive summary of this Report.
 - Section 3: I provide some background information regarding the regulatory environment in which RSAI, MIC and Mercantile (collectively, “the Companies”) operate, and regarding the regulatory environment in which Cavello Bay operates.
 - Section 4: I provide some background information regarding the Companies themselves.
 - Section 5: I summarise the key provisions of the Scheme.

- Section 6: I consider the likely impact of the Scheme on the policyholders whom the Scheme would move from RSAI and from MIC to Mercantile (collectively “the Transferring Policyholders”, respectively “the RSAI Transferring Policyholders” and “the MIC Transferring Policyholders”).
- Section 7: I consider the likely impact of the Scheme on the policyholders who would remain within RSAI and MIC after the transfer has taken place.
- Section 8: I cover more general issues relating to the Scheme and the management of RSAI, MIC and Mercantile.

1.44 I summarise my conclusions in Section 9.

RELIANCES AND LIMITATIONS

- 1.45 In carrying out my review and producing this Report, I have relied, without detailed verification, upon the accuracy and completeness of the data and information provided to me, in both written and oral form, by Mercantile, MIC and RSAI. Reliance has been placed upon, but not limited to, the information detailed in Appendix G. My opinions depend on the substantial accuracy of this data, information and the underlying calculations. I am unaware of any issue that might cause me to doubt the accuracy of the data and other information provided to me. All information that I have requested in relation to my review has been provided. I have been assisted in my review of the information and my analyses by my colleagues at Milliman but I have not relied on their work or their advice. I note in paragraph 8.29 that I have seen some legal advice sought by RSAI and MIC and I have described there how I have used that advice and why I thought it reasonable to use it in that way. I have neither sought nor relied on any other legal advice.
- 1.46 The Report has been prepared for the purposes of the Scheme in accordance with Section 109 of FSMA. A copy of this Report will be sent to the FCA and PRA, and will accompany the Scheme application to the Court.
- 1.47 The Report must be considered in its entirety as individual sections, if considered in isolation, may be misconstrued.
- 1.48 Neither this Report, nor any extract from it, may be published without me having provided my specific written consent, save that copies of this Report may be made available for inspection by policyholders who might be affected by the Scheme and copies may be provided to any person requesting the same in accordance with legal requirements. I also consent to this Report being made available on the website dedicated to the Scheme.
- 1.49 No summary of this Report may be made without my express consent. I will provide a summary of this Report (the “Report Summary”) for inclusion in a document that will be made available to the affected policyholders of MIC and RSAI, to the lawyers and brokers dealing with or representing individual claimants in relation to the Transferring Business, to the affected reinsurers of MIC and RSAI, to the managers of various insurance pools, business of which is included within the Transferring Business, and to other relevant bodies, e.g. to anyone who has been identified as having an interest in the policies being transferred or who has notified RSAI, MIC or Mercantile of their interest (further details are provided in paragraphs 5.55-5.57 below). That document will be sent to both the FCA and the PRA, will accompany the Scheme application to the Court, and will be available on the website dedicated to the Scheme.
- 1.50 This Report has been prepared within the context of the assessment of the terms of the Scheme, and must not be relied upon for any other purpose. No liability will be accepted by Milliman, or me, for any 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. In particular, no liability will be accepted by Milliman or me under the terms of the Contracts (Rights of Third Parties) Act 1999.
- 1.51 Actuarial estimates are subject to uncertainty from various sources, including changes in claim reporting patterns, claim settlement patterns, judicial decisions, legislation, economic and investment conditions. Therefore, it should be expected that the actual emergence of claims, premiums, expenses and investment income will vary from any estimate. Such variations in experience could have a significant effect on the results and conclusions of this Report. No warranty is given by Milliman or me that the assumptions, results and conclusions on which this Report is based will be reflected in actual future experience.

- 1.52 This review does not comprise an audit of the financial resources and liabilities of RSAI, MIC or Mercantile, or of either the wider RSA Group or the wider Enstar Group.
- 1.53 The Report should not be construed as investment advice.
- 1.54 Nothing in this Report should be regarded as providing a legal opinion on the effectiveness of the Scheme.
- 1.55 In considering the background to the companies involved in the Scheme, and in considering the likely impact of the Scheme, I have made extensive use of financial information as at 31 December 2017 as that is, in general, the most recent date at which audited financial information is available. I have also taken into account updated financial information that has been made available to me, although I note that this updated information has not been audited and that, in general, it has not been publically disclosed. I have asked the managements of RSAI, MIC, Mercantile and Cavello Bay for information regarding any developments between 31 December 2017 and the date of this Report that would have affected those companies, in particular any development that might have affected the security of their policyholders and the standards of service provided to them, both now and in future. I have referred in this Report to the developments that they have reported to me. The managements of RSAI, MIC, Mercantile and Cavello Bay have assured me that there have been no other such developments. I have also searched using on-line resources for information regarding any such developments. At the date of this Report, I am not aware of any material changes in circumstances since 31 December 2017 other than those referred to in this Report. The Report also takes no account of any information that I have not received, or of any inaccuracies in the information provided to me. I will review all further audited financial statements of RSAI, MIC, Mercantile and Cavello Bay as and when they become available, and will comment on this information in my Supplementary Report.
- 1.56 I have relied on the currency exchange rates found in the financial statements and in other information provided. When conversion of currency values were necessary, unless stated otherwise, the rates of exchange used in this Report are £1.00 = US\$1.35 = €1.13 as at 31 December 2017, consistent with the rates of exchange used by RSAI in preparing the reserves for inclusion within the RSAI Annual Report 2017.
- 1.57 The use of Milliman's name, trademarks or service marks, or reference to Milliman directly or indirectly in any media release, public announcement or public disclosure, including in any promotional or marketing materials, websites or business presentations, is not authorised without Milliman's prior written consent for each such use or release, which consent shall be given in Milliman's sole discretion.

PROFESSIONAL AND REGULATORY GUIDANCE

- 1.58 I am required to comply with relevant professional standards and guidance maintained by the Financial Reporting Council and by the Institute and Faculty of Actuaries, including *TAS 100: Principles for Technical Actuarial Work* and *TAS 200: Insurance*. I have complied with such standards, subject to the principles of proportionality and materiality.
- 1.59 In accordance with *Actuarial Profession Standard X2*, as issued by the Institute and Faculty of Actuaries, I have considered whether this Report should be subject to review ("Work Review"). I concluded that it should and I have also decided that the Work Review should be conducted by an individual who has not otherwise been involved in the analysis underlying this Report or in the preparation of this Report, but who would have had the appropriate experience and expertise to take responsibility for the work himself. In other words, I have decided that this Report should be subject to Independent Peer Review. I confirm that this Report has been subject to Independent Peer Review prior to its publication.
- 1.60 This Report has been prepared under the terms of the guidance set out in the Statement of Policy entitled *The Prudential Regulation Authority's approach to insurance business transfers* ("the Policy Statement"), issued in April 2015, and in Section 18 of the FCA Supervision Manual ("SUP18") contained in the Handbook of Rules and Guidance to cover scheme reports on the transfer of insurance business. I have also followed the guidance contained within the FCA's May 2018 paper on Part VII Transfers (FG18/4).

2. EXECUTIVE SUMMARY

CONCLUSION

- 2.1 The policyholders transferring from RSAI will be moving from a large insurance company to Mercantile, a much smaller insurance company. The policyholders transferring from MIC will be moving to Mercantile from an insurance company that is smaller than Mercantile post-Scheme, but one in which their policies currently benefit from the additional protection of being 100% reinsured by RSAI. Therefore, it is clear to me that the security of benefits of the Transferring Policyholders will be diminished through differences in the relative financial strength of Mercantile post-Scheme, relative to RSAI and MIC pre-Scheme. In my opinion, provided the proposed Scheme operates as intended, and I have no grounds for believing that it will not do so:
- The security of benefits to policyholders of RSAI and MIC who are not being transferred under the Scheme will not be materially adversely affected by the implementation of the Scheme on the Effective Date;
 - While the security of benefits to policyholders of RSAI and MIC who are being transferred under the Scheme will be adversely affected by the implementation of the Scheme on the Effective Date, the diminution will not be material; and
 - The Scheme will have no impact on service standards (operated in accordance with Treating Customers Fairly (“TCF”) criteria) experienced by the policyholders of RSAI and MIC, both those being transferred under the Scheme and those not transferring.
- 2.2 I note that there are currently no policyholders within Mercantile and that there will be none prior to the Effective Date.
- 2.3 I summarise below the key aspects of the Scheme, the aspects of the Scheme that I considered, and the conclusions that I reached in respect of those aspects.
- 2.4 I will review my analyses and conclusions in the light of any relevant information of which I become aware prior to the Court hearing to sanction the Scheme, and I will summarise my additional review and conclusions, explaining any revisions to those contained within this Report, in a Supplementary Report.

THE SCHEME

- 2.5 Under the Scheme, the Transferring Business, including the Transferring Assets and Transferring Liabilities, will be transferred to Mercantile (the Transferee) from RSAI and MIC (the Transferors). The Transferring Business, net of the benefit of any attaching reinsurance, is already entirely reinsured by Cavello Bay, under the Reinsurance Agreement. Therefore, the Transferring Assets are the legal ownership of reinsurance covers, purchased to reinsure the Transferring Business at or subsequent to the time the risks were originally written, as well as the Reinsurance Agreement, other third party contracts, reinsurance recoveries, salvage and subrogation rights, and the books and records of the Transferring Business.
- 2.6 By a Deed of Amendment, the terms of the Reinsurance Agreement will be amended on and with effect from the Effective Date such that, post-Scheme, Mercantile will be 75% reinsured by Cavello Bay in respect of the Transferring Business. As at the Effective Date, there will be a return of premium from Cavello Bay to Mercantile in respect of the 25% of the liability relating to the Transferring Business that Cavello Bay no longer reinsures but which is, post-Scheme, retained by Mercantile.

Motivation for the Scheme

- 2.7 The Transferring Business comprises risks written mostly prior to 2006 that are now considered by RSAI and MIC to be non-core. With effect from 7 February 2017, RSAI entered into an agreement whereby Cavello Bay² 100% reinsures the RSAI Transferring Business as well as RSAI's 100% reinsurance of the MIC Transferring Business. Thus, the economic liability for the Transferring Business currently lies wholly with Cavello Bay, and the net liability for the Transferring Business within both RSAI and MIC is nil.
- 2.8 The purpose of the proposed Scheme is to provide legal finality for RSAI and MIC in respect of the Transferring Business, in order to match the economic finality provided by the Reinsurance Agreement.

Policyholders Affected

- 2.9 I have considered the effects of the Scheme on the following groups of policyholders:
- the RSAI Transferring Policyholders (including individuals with outstanding claims in respect of those policies);
 - the MIC Transferring Policyholders (including individuals with outstanding claims in respect of those policies);
 - the current policyholders of RSAI who have policies that are not being transferred under the Scheme; and
 - the current policyholders of MIC who have policies that are not being transferred under the Scheme.
- 2.10 I would usually expect to consider the effects of the Scheme on the current policyholders of Mercantile. However, following the Part VII transfer to River Thames Insurance Company Limited of the then remaining business of Mercantile that was effective on 7 April 2017, there are currently no policyholders of Mercantile and so I have not considered this matter any further.

Administration

- 2.11 Responsibility for the administration of the Transferring Business will move from RSAI to Mercantile as a result of the Scheme. Following completion and full implementation of the Separation and Migration Plan (whereby the policy and claims records relating to the Transferring Business are transferred to Mercantile's policy and claims administration systems from those of RSAI and MIC), Mercantile will outsource the administration to Enstar (EU) Limited ("EEUL"), which is a UK based non-regulated service company and another member of the Enstar Group. Those staff currently employed by RSAI and who currently perform the management and claims handling of the Transferring Business will be transferred to EEUL under the terms of the BTA.
- 2.12 It is expected that the Separation and Migration Plan will be completed and fully implemented during the quarter following the Effective Date. The date on which this occurs is referred to as the Migration Date. Therefore, to ensure the continuity of policy servicing and the maintenance of servicing standards post-Effective Date, Mercantile and RSAI have agreed that, between the Effective Date and the Migration Date, RSAI will continue to provide all policy servicing in respect of the Transferring Business on behalf of Mercantile under an outsourcing agreement. As part of this agreement, the staff who will be transferred on the Effective Date from RSAI to EEUL under the terms of the BTA will be immediately seconded back to RSAI, until the Migration Date.

THE IMPACT OF THE SCHEME UPON THE TRANSFERRING POLICYHOLDERS

- 2.13 I am satisfied that the proposed Scheme does not affect in a materially adverse way either the security or the policy servicing levels of the Transferring Policyholders. I have reached this conclusion by considering:
- the reserves of the Companies as at 31 December 2017 (and subsequently where available);

2 Initially, the reinsurer was Fitzwilliam, pending Cavello Bay obtaining the necessary regulatory approvals to be able to accept the Reinsurance Agreement. Those approvals having been obtained, the Reinsurance Agreement was novated from Fitzwilliam to Cavello Bay in May 2017.

- the excess assets of the Companies as at 31 December 2017 (and subsequently where available);
- the structure of the (post-Scheme) Reinsurance Agreement and the security afforded it by Cavello Bay and by the guarantee provided by EGL;
- the risk exposures in the Companies and the impact that the Scheme might have on those; and
- the standards of policy servicing in each of the Companies.

2.14 I have also considered how the excess assets of Mercantile, Cavello Bay and EGL, and, ultimately, the ability of Mercantile to meet its obligations to the Transferring Policyholders, might be affected, post-Scheme, by specific extreme scenarios.

2.15 I concluded that:

- the reserves of RSAI and MIC appeared reasonable as at 31 December 2017, as do those of Mercantile on a pro forma basis;
- there is no reason to think that the reserve strength of RSAI, MIC or Mercantile will be impacted by the Scheme;
- as at 31 December 2017, RSAI is a well-capitalised company, MIC is a very well-capitalised company, and, on a pro forma basis, Mercantile is a more than sufficiently capitalised company (I have defined these terms in paragraph 6.5 below);
- the policyholders of the Transferring Business will not be materially adversely affected due to relative differences in the financial strength of Mercantile post-Scheme to those of RSAI and MIC pre-Scheme;
- although the proposed Scheme will lead to a change to the risk exposures of the Transferring Business, this will not have a materially adverse impact on the security of policyholder benefits; and
- the proposed Scheme is unlikely to have any impact on the standards of policy servicing experienced by the Transferring Policyholders compared to their current position.

THE IMPACT OF THE SCHEME UPON THOSE POLICYHOLDERS REMAINING WITHIN THE TRANSFERORS

2.16 I have concluded that the Scheme would have negligible impact on those policyholders remaining within the Transferors.

2.17 In reaching this conclusion, I have noted that MIC business is 100% reinsured into RSAI and so those policyholders remaining within MIC will continue to rely on the financial strength of RSAI for the security of their benefits. I have also noted that the RSAI Transferring Business represents a small proportion of the gross liabilities within RSAI and the RSAI Transferring Business liabilities, together with those in respect of RSAI's reinsurance of the MIC Transferring Business, have already been 100% reinsured into Cavello Bay.

THE IMPACT OF THE SCHEME IN RESPECT OF OTHER MATTERS

2.18 I have considered the likely effects of the Scheme on the reinsurers whose reinsurance contracts cover the Transferring Business. I am satisfied that the Scheme will not have a materially adverse effect on those reinsurers. The administration of the Transferring Business, including the management and handling of claims, will continue to be performed post-Scheme by mostly the same people, using the same processes, as it had been pre-Scheme, through the transfer of the Assumed Employees from RSAI to EEUL, so the magnitude and timing of recoveries claimed against reinsurance contracts relating to the business to be transferred will be unaffected by the Scheme.

2.19 I have been informed by Enstar and RSAI that the Scheme is not expected to have tax implications that would affect any of the Companies or any of the groups of policyholders identified in paragraph 2.9 above (save that Mercantile would be subject to Corporation Tax on any profit emerging from the run-off of the Transferring Business). I have seen correspondence that supports this view in respect of the treatment of the Scheme for Valued Added Tax ("VAT").

- 2.20 RSAI and Enstar have estimated the external costs of the Scheme at between £3.2 million and £3.4 million, to be shared between RSAI/MIC and Mercantile in accordance with the BTA. I consider it unlikely that the costs of the Scheme will be such as to jeopardise the security of any of the groups of policyholders.

APPROACH TO COMMUNICATION WITH POLICYHOLDERS

- 2.21 RSAI and MIC intend to notify the RSAI Transferring Policyholders and the MIC policyholders (both those transferring and those not transferring) directly or via appropriate intermediaries, such as the managers of insurance pools that contain some Transferring Business. The full list of those whom they intend contacting is set out in paragraph 5.55 below.
- 2.22 RSAI does not intend to notify directly any of its policyholders whose policies are not included within the Transferring Business on the basis that, as the relevant liabilities are already with the Enstar Group, through Cavello Bay's reinsurance of the RSAI Transferring Business, the impact of the Scheme on the remaining policyholders is expected to be slight, their relationship with RSAI will not be affected by the Scheme, there will be no change to the terms and conditions of their contracts, and the costs of such communication would be disproportionate to the likely benefits to the affected parties. Accordingly, RSAI will be applying to the Court for appropriate waivers of the requirement for it to notify all of its policyholders.
- 2.23 In addition to direct, written correspondence with Transferring Policyholders or with identified intermediaries, the Companies also plan indirect notification via advertisements in appropriate publications, including at least two national newspapers, together with both international financial publications and specialist industry publications.
- 2.24 The letters, notices and advertisements will refer all queries to a postal address or a telephone number or a website address, all of which will be dedicated to responding promptly to any such queries.
- 2.25 In the circumstances I regard the proposed approach to communications to be reasonable and proportionate, and the draft communications to be clear, fair and appropriate for their intended audiences.

3. BACKGROUND REGARDING THE REGULATORY ENVIRONMENTS

3.1 In this Section of the Report, I describe the general insurance markets and the regulatory regimes that operate in the UK and in Bermuda, the latter being where Cavello Bay is domiciled, authorised and regulated.

OVERVIEW OF UK INSURANCE REGULATION

Background

3.2 UK insurers, as well as other financial services organisations, are regulated by both the PRA and the FCA using a system of dual regulation. The PRA and the FCA are statutory bodies set up under FSMA and the Financial Services Act 2012; their roles and objectives are defined by FSMA (as amended).

3.3 The PRA is part of the Bank of England and is responsible for:

- Prudential regulation of banks, building societies and credit unions, insurers and major investment firms;
- Promoting the safety and soundness of the firms it regulates, seeking to minimise the adverse effects that they can have on the stability of the UK financial system; and
- Contributing to ensuring that insurance policyholders are appropriately protected.

3.4 The FCA is a separate institution and is responsible for:

- Ensuring that the markets that it regulates function well;
- Conduct regulation of all financial firms; and
- Prudential regulation of those financial services firms that are not supervised by the PRA.

3.5 A Memorandum of Understanding has been established between the PRA and the FCA, which sets out the high level framework by which these two regulatory bodies will co-ordinate. In particular, the Memorandum of Understanding requires the PRA and FCA to co-ordinate with each other in advance of Part VII transfers.

3.6 The PRA sets the regulations governing the amount and quality of solvency capital held by firms; these are summarised below. The solvency regime is designed to protect the security of policyholders, as well as the stability of the insurance industry.

3.7 The FCA is concerned with achieving fair outcomes for consumers and seeks to ensure that firms adhere to its conduct principles. Its strategic objective is to ensure that the relevant markets function well. To support this, it has three operational objectives, which are:

- To secure an appropriate degree of protection for consumers;
- To protect and enhance the integrity of the UK financial system; and
- To promote effective competition in the interests of consumers.

Taxation

3.8 In the UK, general insurance companies are taxed on profits achieved at the main rate of corporation tax (currently 19%³ for the financial year ending 31 March 2019).

3 The UK Corporation Tax rate is expected to reduce to 17% with effect from 1 April 2020.

Financial Services Compensation Scheme

3.9 As well as through the PRA and FCA regulations, consumer protection is also provided by the Financial Services Compensation Scheme (“FSCS”). This is a statutory “fund of last resort”, which compensates customers in the event of the insolvency (or other defined default) of a financial services firm authorised by the PRA or FCA, subject to certain eligibility rules. Insurance protection exists for private policyholders and small businesses⁴ that hold eligible policies in the situation when an insurer is unable to meet fully its liabilities. For general insurance business, the FSCS will pay 100% of any claim incurred before the default:

- In respect of a liability subject to compulsory insurance (such as employers’ liability cover); or
- That arises in respect of a liability subject to professional indemnity insurance; or
- That arises from the death or incapacity of the policyholder due to injury, sickness, or infirmity

and 90% of any claim incurred before the default for other eligible types of insurance (such as home insurance). No protection is available for Goods in Transit, Marine, Aviation and Credit Insurance. Contracts of reinsurance are also not protected. The FSCS is funded by annual levies on all firms regulated by the PRA and by the FCA, with separate tariffs for each of five broad classes of activity (deposits, life and pensions, general insurance, investments and home finance).

Financial Ombudsman Service

3.10 The Financial Ombudsman Service (“FOS”) provides private individuals (and micro enterprises⁵) with a free, independent service for resolving disputes with financial companies. It is not necessary for the private individual (or micro enterprise) to live or be based in the UK for a complaint regarding an insurance policy to be dealt with by the FOS; it is necessary for the insurance policy concerned to be, or have been, administered from within the UK.

FCA Conduct Principles

3.11 Within its document “*Fair treatment of customers*”, the FCA sets out six consumer outcomes that firms should strive to achieve to ensure fair treatment of customers. These remain core to what the FCA expects of firms. These are as follows:

- Outcome 1: Consumers can be confident that they are dealing with insurers where the fair treatment of customers is central to the corporate culture;
- Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;
- Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;
- Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances;
- Outcome 5: Consumers are provided with products that perform as insurers have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and
- Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by insurers to change product, switch provider, submit a claim or make a complaint.

4 In accordance with Section 382 of the Companies Act 2006, a small business is defined as one for which two of the following three conditions apply over the preceding financial year: turnover not more than £10.2 million; balance sheet not more than £5.1 million; and not more than 50 employees.

5 Micro-enterprises (an EU term covering smaller businesses) can bring complaints to the FOS as long as they have an annual turnover of less than €2 million and fewer than ten employees.

- 3.12 These principles, which are often summarised as “Treating Customers Fairly” (“TCF”), apply even for firms that do not have direct contact with retail customers. The FCA’s rationale is that risks and poor conduct can be carried from wholesale to retail markets.

The Insurers (Reorganisation and Winding-Up) Regulations 2004

- 3.13 Under UK law, the winding-up of an insurance undertaking is governed by the *Insurers (Reorganisation and Winding-Up) Regulations 2004* (as amended, including under the Solvency II Regulations 2015). Under these regulations, insurance claims have precedence over any claim on the insurance undertaking with the exception of certain preferential claims (e.g. claims by employees, etc.) with respect to the whole of the insurance undertaking’s assets. Therefore, direct policyholders rank equally and above inwards reinsurance policyholders and all other unsecured/non preferential creditors in the event that an insurer is wound up.

SOLVENCY CAPITAL FRAMEWORK (SOLVENCY II)

- 3.14 The regulatory solvency reporting requirements for (re)insurers regulated within the EU underwent a major change with effect from 1 January 2016. The new regime, which is commonly referred to as Solvency II, has introduced, consistently across the EU, solvency requirements that reflect the risks that individual (re)insurers actually face. The previous pan-European regime, Solvency I, was based purely on the level of premiums received and claims paid by an insurer, and did not consider the risks faced by the business. Regulators in several countries, including the UK, had then overlaid a more rigorous regime, resulting in inconsistency between EU member countries. Solvency II has superseded all of these locally imposed solvency regimes.
- 3.15 Under Solvency II, EU (re)insurers are now required to adhere to a set of risk-based capital requirements, some of the results of which will be shared with the public.
- 3.16 Solvency II is a principles-based regime, based on three so-called pillars:
- Under Pillar I, quantitative requirements define a market consistent framework for valuing the company’s assets and liabilities, and determining the Solvency Capital Requirement (“SCR”).
 - Under Pillar II, insurers must meet minimum standards for their corporate governance, and also for their risk and capital management. There is a requirement for internal audit and actuarial functions. Insurers must regularly complete an Own Risk and Solvency Assessment (“ORSA”).
 - Under Pillar III, there are explicit requirements governing disclosures to supervisors and policyholders.
- 3.17 Under Solvency II, both the assets and liabilities of insurers are valued on a market consistent basis. Therefore, under Solvency II, the Technical Provisions in respect of claims incurred and losses arising from unexpired exposures (together typically the largest item on the liability side of an insurer’s balance sheet, and hence the balance sheet itself) are often substantially different from those calculated under the current requirements for IFRS/GAAP.
- 3.18 I set out in Appendix H simplified details for the balance sheet, and the calculation of Technical Provisions (in respect of claims incurred and losses arising from unexpired exposures), for an insurer under Solvency II.
- 3.19 The Technical Provisions required under Solvency II as relating to general insurance business are:
- The premium provision: the expected present value (with no allowance for optimism or prudence) of all future cash-flows (claim payments, expenses and future premiums due) relating to future exposures arising from policies for which the insurer is obligated as at the valuation date;
 - The claims provision: the expected present value (with no allowance for optimism or prudence) of all future cash-flows (claim payments, expenses and future premiums due) relating to claim events prior to the valuation date; and

- The risk margin: the risk margin is intended to represent the balance that another (re)insurer would require over and above the sum of the premium provision and claims provision for taking on the liabilities at the valuation date. Under Solvency II, the risk margin is calculated using a cost-of-capital approach (presently employing a 6% cost of capital parameter as set out in EU regulation⁶).
- 3.20 The Technical Provisions in respect of claims required under Solvency II differ from the GAAP claims reserves as follows:
- The Technical Provisions contain no element of conservatism above a best estimate that may be held in the undiscounted GAAP reserves;
 - The Technical Provisions include an allowance for events not in data (“ENID”), which are events or future developments that might occur but which are not represented in the historical data upon which the actuarial projections are based;
 - The Technical Provisions include a discount to account for the time value of money in the future cash flows; and
 - The Technical Provisions include a risk margin.
- 3.21 The SCR under Solvency II is the amount of capital required to ensure continued solvency over a one-year period with a probability of 99.5%. There are two main approaches to calculating the SCR:
- Using an internal model approved by the local supervisor: an internal model calculation of the SCR is based upon an assessment of the risks specific to an insurer, and is calibrated so as to correspond to a confidence level of 99.5% over a one-year trading period that net assets remain positive (i.e. the insurer remains solvent); or
 - Using the standard formula specified in detail in the Solvency II legislation: the standard formula is designed to be applicable to all insurers and is not therefore tailored to the circumstances of an individual insurer. In summary, the basic SCR consists of 5 risk modules (non-life, life, health, market and counterparty) that are in turn further subdivided into 18 sub-modules (e.g. premium and reserve risk, catastrophe risk and currency risk). The results for each sub-module are aggregated using a correlation matrix to arrive at a capital charge for each of the 5 main modules, which in turn are aggregated using a further correlation matrix to determine the basic SCR. A further module is used to calculate operational risk, which is added to the basic SCR to produce the (standard formula) SCR.
- 3.22 The Minimum Capital Requirement under Solvency II (“MCR”) defines the point of intensive regulatory intervention. The MCR calculation is less risk sensitive than the SCR calculation and is calibrated to a confidence level of 85% over a one-year period (compared to 99.5% for the SCR). The MCR is calculated as a linear function of the Technical Provisions and written premium but must be between 25% and 45% of the firm’s SCR, subject to an absolute floor of €2.5 million (or €3.7 million for (re)insurers writing liability, credit or suretyship classes).
- 3.23 If an insurer’s available resources fall below the SCR, then supervisors are required to take action with the aim of restoring the insurer’s finances back to the level of the SCR as soon as possible. If, however, the financial situation of the insurer continues to deteriorate, then the level of supervisory intervention will be progressively intensified. The aim of this “supervisory ladder” of intervention is to capture any ailing insurers before their situation becomes a serious threat to policyholders’ interests. If the available resources of the insurer were to fall below the level of the MCR, then “ultimate supervisory action” would be triggered, i.e. the insurer’s liabilities would be transferred to another insurer and the licence of the insurer would be withdrawn, or the insurer would be closed to new business and its in-force business placed into run-off. In practice, supervisors would be expected to have determined earlier whether or not the insurer’s finances could be restored to above the level of the SCR – an insurer whose supervisor determined that it would not be able to restore its solvency position would be placed into run-off before it breached its MCR.

6 Commission Delegated Regulation (EU) 2015/35 dated 10 October 2014.

Brexit

- 3.24 In the UK Referendum on Continuing EU Membership in June 2016, the majority of participants voted for the UK to leave the EU. On 29 March 2017, in a letter to the EU Council, the UK Government triggered Article 50 of the Lisbon Treaty and formally started the process by which the UK will leave the EU (commonly referred to as “Brexit”). Article 50 of the Lisbon Treaty gives both sides two years to reach agreement on the terms of such an exit so, unless the UK and all of the remaining EU member states agree to extend the deadline for negotiating those terms, the UK will cease being a member state of the EU on or before 29 March 2019.
- 3.25 I consider some of the other possible impacts of Brexit as they might affect the Scheme later in this Report, but at this stage I note that, following Brexit, the UK Government might seek to cancel certain pieces of legislation that were enacted in accordance with EU Directives. One such legislative item might be that which implemented Solvency II. However, I note the following :
- The UK played a prominent role in the development of Solvency II;
 - The costs for the insurance industry of implementing Solvency II were considerable and it is likely that the costs of implementing a replacement solvency regime that was materially different from Solvency II would also be very large;
 - Solvency II took many years to develop and to implement, and it is likely that any materially different replacement solvency regime would also take a long time to develop and to implement;
 - There is a strong desire within the UK insurance industry that the UK solvency and prudential regime maintains “equivalence” with the Solvency II regime that will remain in place throughout the remaining countries of the EU, to facilitate cross-border operations without unnecessary duplication of regulation; and
 - A UK Treasury Select Committee was formed in September 2016 to consider the Solvency II Directive, its impact on the UK insurance industry and what improvements could be made in the interests of the consumer. The Committee reported in October 2017. While it called for the development of a clear agreed strategy to refine the Directive post-Brexit in order to foster innovation, competition and competitiveness for the benefit of UK consumers, it did not recommend the dismantling of the Directive; rather it looked for greater harmonisation between UK insurance and international capital standards and emerging accounting standards.
- 3.26 Therefore, notwithstanding Brexit, I believe it to be very unlikely that there will be any material change to the UK solvency capital regime in the short to medium term. I have therefore not considered further this possibility in this Report.
- 3.27 It is possible that the negotiations between the UK and EU regarding the terms of Brexit will result, post-Brexit, in continuation of the current passporting regime for UK insurers, or at least in some transitional arrangements that enable insurers to carry on cross UK/EEA border activities for a fixed period after March 2019. However, most insurers currently operating across UK/EEA borders are making contingency plans in case the existing passporting arrangements are discontinued promptly on Brexit. Some that are UK based are establishing a regulated entity in a (continuing) EU-member country, from which non-UK EEA business can be conducted and into which existing non-UK EEA business can be transferred. Others are considering what additional requirements will be imposed upon them to enable them to continue to be able to conduct cross-border EEA activities as, in effect, third country insurers.

OVERVIEW OF BERMUDA INSURANCE REGULATION

Background

- 3.28 Insurance supervision of both domestic insurance companies and international insurers and reinsurers and exempt companies is conducted by the Insurance Department of the Bermuda Monetary Authority (“BMA”), an independent body that acts as Bermuda’s financial system regulator.
- 3.29 Domestic insurance companies, international (or exempt) (re)insurance companies and captives are all governed by the same insurance legislation. The Insurance Act 1978 and its subsequent amendments provide the main structure for insurance activities in Bermuda.

- 3.30 Although it provides the BMA with substantive licensing and intervention powers, the Insurance Act 1978 was designed to make the market largely self-regulating. Each company is required to employ an approved auditor and to appoint a principal representative. This representative is legally obliged to report to the BMA if he/she has reason to believe that the company is likely to become insolvent or is in breach of any condition imposed on its operations. In addition, insurers in classes 2, 3 and 4 (see below) are obliged to file regular reports on their loss reserves by a loss reserve specialist also approved by the BMA.
- 3.31 The BMA's general approach involves the application of more rigorous scrutiny and more onerous requirements where material amounts of business are transacted with unrelated parties. In addition, it places a greater reliance on transparency and ongoing disclosure where counterparties are sufficiently expert and sophisticated to be reasonably expected to understand and judge the underlying risks, and to determine their degree of tolerance for them.
- 3.32 Bermuda has a multi-license system of regulation that:
- Categorises general (re)insurance companies into six classes and long-term (re)insurance companies into five classes;
 - Has a separate class for Special Purpose Insurers; and
 - Provides for composite companies.
- 3.33 An insurer is categorised as **Class 1** if it is a single-parent captive insurance company underwriting only the risks of the owners of the insurance company and affiliates of the owners. Class 1 insurers are required to maintain minimum capital and surplus (the Minimum Margin of Solvency or "MSM") of US\$120,000 – the MSM is an absolute floor for the required solvency capital of Bermuda-regulated insurer.
- 3.34 An insurer is categorised as **Class 2** if it is either
- Owned by unrelated entities, provided that the captive underwrites only the risks of the owners and affiliates of the owners and/or risks related to or arising out of the business or operations of the owners and affiliates; or
 - A single-parent and multi-owner captive with no more than 20% of its net premiums being derived from risks that are not related to, or arising out of, the business or operations of their owners and affiliates.
- The MSM for Class 2 insurers is US\$250,000.
- 3.35 An insurer is categorised as **Class 3** if it is not included within Classes 1, 2, 3A, 3B and 4 (or as a Special Purpose Insurer). This class includes structured reinsurers writing third party business; insurers writing direct policies with third party individuals; and single-parent, group, association, agency or joint venture captives where more than 20% and less than 50% of its net written premium must arise from unrelated sources.
- 3.36 For an insurer to be categorised as **Class 3A**
- 50% or more of its net written premiums, or 50% or more of its loss and loss expense provisions, must be in respect of unrelated business; and
 - Its total net written premiums from unrelated business are less than US\$50 million.
- 3.37 For an insurer to be categorised as **Class 3B**
- 50% or more of its net written premiums, or 50% or more of its loss and loss expense provisions, must be in respect of unrelated business; and
 - its total net written premiums from unrelated business are equal to or more than US\$50 million.
- 3.38 The MSM for insurers in Class 3, Class 3A or Class 3B is US\$1 million.
- 3.39 An insurer is categorised as **Class 4** if it intend to carry on insurance business including excess liability business and property catastrophe reinsurance. The MSM for Class 4 insurers is US\$100 million.

- 3.40 Actuarial certification of insurance liabilities is required annually for insurers in Classes 3, 3A, 3B and 4. Such certification is required tri-annually for Class 2 insurers.
- 3.41 A **Special Purpose Insurer** is one that carries on "special purpose business". They are special purpose, single transaction, or single customer insurance companies that assume (re)insurance risks and that typically fully fund their exposure to such risk. Examples include sidecars and catastrophe bonds. Guidance Note No 20 (Special Purpose Insurers) details the BMA's supervisory approach.
- 3.42 To be categorised as a Special Purpose Insurer, an insurer would have to meet the following criteria:
- It would be carrying on insurance business in the area of insurance-linked securitisations;
 - It would be established to enter into a single transaction or a single set of transactions;
 - Its obligations would be fully collateralised; and
 - Transactions would be carried out with a limited number of sophisticated participants.

Taxation

- 3.43 Corporation tax is not levied in Bermuda.

Consumer protection

- 3.44 Insurance in Bermuda is a business-to-business market where buyers and sellers of insurance are considered to be equally sophisticated. Aside from four domestic insurance groups, there are no retail insurance companies regulated in Bermuda. As such, there are no specific consumer protection regulations in place.
- 3.45 In cases of consumer dispute resolution, the Bermudan government has encouraged the use of arbitration through the Bermuda International Conciliation and Arbitration Act 1993, which incorporates the model law provisions of the United Nations Commission on International Trade Law. Bermuda has established a register of internationally recognised insurance and reinsurance arbitrators and has opened a dedicated international arbitration centre at the Bermuda College.
- 3.46 Bermuda is also a party to the New York Convention, thus giving recognition to other convention countries in respect of the enforcement of arbitral awards.
- 3.47 There is no policyholders' protection fund or other mechanism for compensating the policyholders of insolvent (re)insurance companies.

Reserving

- 3.48 Insurers must set aside in their statutory accounts an "adequate amount" for incurred and IBNR losses and for loss adjustment expenses, which may be reduced by the amount of anticipated reinsurance recoveries. There are no regulations regarding the calculation of these "adequate amounts". However, for Classes 2-4, as explained above in paragraph 3.40, insurers have to provide periodical actuarial certification of their provisions for claims and for loss adjustment expenses.
- 3.49 Discounting of loss reserves is allowed but only in limited circumstances. Where loss reserves are discounted, the insurer must make a provision for potential adverse deviations in loss amounts, payment dates and interest rates.

Solvency capital

- 3.50 The BMA's standard risk-based capital adequacy measure, the Bermuda Solvency Capital Requirement ("BSCR"), was initially implemented in 2008. The BSCR applies capital charges to the premium and claims liabilities of individual business classes, based on the characteristics of each class. The model also applies capital charges in respect of inherent business risks such as catastrophe risk, interest rate risk, credit risk and operational risk.

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- 3.51 Along with their statutory financial returns to the BMA, general insurers are required to include a general business solvency certificate. If an insurer has failed to meet its solvency requirement, details of corrective action being undertaken must be attached to the certificate.
- 3.52 Where an insurer believes that its own internal model better reflects the inherent risks of its business it may apply to the BMA for this to be used for determining its regulatory capital requirement in preference to the standard model. Before approving an internal model, the BMA will consider, among other things, the extent to which the model has been integrated into the insurer's enterprise risk management programme so that it is used by both the insurers' board of directors and senior management as a tool for formulating business strategy. The internal model must be calibrated to approximately 99% of the tail value at risk over a one-year period (which is roughly equivalent to a confidence level of 99.5%), with full run-off. The insurer must also demonstrate that it has built a risk margin into its reserves that is equivalent to the cost of capital (or the cost required to transfer its portfolio to another (re)insurer in the event of insolvency).
- 3.53 All (re)insurers regulated in Bermuda are expected to hold capital at least equal to the Enhanced Capital Requirements ("ECR"). An insurer's ECR is calculated as the higher of the SCR calculated using the standard BSCR model and that calculated using its approved internal model (if it has one), provided that the ECR amount is equal to or exceeds the MSM.
- 3.54 Under both the standard BSCR model and any internal capital model, an insurer will be deemed to be insolvent if its capital falls below the current MSM.
- 3.55 In order to minimise the risk of a shortfall in capital arising from an unexpected adverse deviation, the BMA seeks that (re)insurers operate at or above a threshold capital level (termed the Target Capital Level ("TCL")). The TCL for Class 3A, Class 3B and Class 4 (re)insurers is set at 120% of the ECR.
- 3.56 Insurers must set aside in their economic balance sheet (should they have one) a "reasonable amount" for incurred and IBNR losses and for loss adjustment expenses, both gross and net of anticipated reinsurance recoveries. The technical provisions in an insurer's economic balance sheet would be expected to differ from those in its statutory accounts. As per the reserves in the statutory accounts, insurers are expected to provide periodical actuarial certification of the technical provisions within their economic balance sheet, albeit that the opinion in respect of the economic balance sheet should certify that the technical provisions are "reasonable" whereas that in respect of the statutory balance sheet certifies that the reserves are adequate.
- 3.57 The BSCR works in tandem with eligible capital requirements and the Commercial Insurers' Solvency Self-Assessment ("CISSA"), which is designed to demonstrate the link between the BSCR, risk governance and decision making. In particular, the CISSA enables the BMA to take insurers' own assessments of the capital amounts that they need into consideration when it conducts its capital assessments for regulatory purposes.
- 3.58 The solvency capital regime imposed by the BMA (other than in respect of captives and special purpose insurers) has been declared to be Solvency II equivalent by the EU. This means that Class 3A, Class 3B, and Class 4 (re)insurers and Bermuda insurance groups will not be subject to additional solvency capital requirements, if and when they do business within the EU.

4. BACKGROUND REGARDING THE ENTITIES CONCERNED IN THE SCHEME

4.1 In this Section of the Report, I set out some background information and key metrics relating to the entities that are involved in the Scheme. I have also included a sub-section relating specifically to the Transferring Business.

RSAI

Background

4.2 RSAI is an insurance company, registered as a public limited company in England and Wales (registered number 00093792) under the Companies Act 2006. It is an indirectly wholly owned subsidiary of RSAIG, which itself is registered as a public limited company in England and Wales (registered number 2339826) under the Companies Act 2006. RSAIG is the ultimate holding company of a multinational insurance group with major operations in the UK, Scandinavia, Canada and Ireland, and the capability to write business in around 140 countries.

4.3 RSAI is the largest insurance operation in the RSA Group. It is jointly regulated by the PRA and the FCA, and is authorised to write general insurance and reinsurance business.

4.4 RSAI's issued and fully paid share capital as at 31 December 2017 was made up of 4,859,811,537 ordinary class A shares of 25p each and 1 ordinary class B share of US\$1⁷.

Business Written

4.5 The main elements of the business written by RSAI are as follows (percentages in brackets are the proportions of total gross premiums written in 2017, which totalled £4,365 million⁸):

- Accident & Health (1%);
- Motor (20%);
- Fire and Property (29%);
- Third Party Liability (7%);
- Marine, Aviation & Transport (7%);
- Inwards Reinsurance (29%); and
- Other (7%).

4.6 89% of the above gross premiums (excluding inwards reinsurance business) related to UK business, 10% related to other EEA business and just 1% related to non-EEA business.

⁷ Based on RSAI's Annual Report as at 31 December 2017, Note 25.

⁸ Based on RSAI's Annual Report as at 31 December 2017, Note 4.

Key financial information

- 4.7 As at 31 December 2017, on a UK GAAP basis, the gross outstanding claims reserves⁹ within RSAI were £4,527 million. In addition, as at 31 December 2017, RSAI held a gross provision for unearned premiums¹⁰ of £2,300 million. The reinsurers' share as at 31 December 2017 of claims outstanding and unearned premiums were £1,091 million¹¹ and £691 million¹² respectively.
- 4.8 RSAI management considers that the UK GAAP booked reserves remain reasonable and within a range of Best Estimates for RSAI.
- 4.9 The outstanding claims reserves shown in the RSAI balance sheet within its Report & Accounts as at 31 December 2017 exclude allowance for the RSAI Transferring Business. As at 31 December 2017, RSAI booked reserves, gross of reinsurance, in respect of the Transferring Business equal to £614 million, comprising £563 million in respect of RSAI Transferring Business and £51 million in respect of RSAI's current reinsurance of the MIC Transferring Business (net of the outwards reinsurance contracts that apply to the MIC Transferring Business). These reserves have been discounted to allow for the time value of money. As this business is in run-off, all of the reserves relate to outstanding claims and there are no premium provisions. The equivalent booked reserves for RSAI, net of outwards reinsurance (but gross of intra-group reinsurance), were £555 million.
- 4.10 The booked reserves in respect of the Transferring Business are the equivalent of 8.3% of the total gross technical provisions (including those relating to the Transferring Business) and 11.9% of total gross outstanding claims reserves (including those relating to the Transferring Business) as at 31 December 2017, all on a GAAP basis.
- 4.11 As noted in paragraph 1.11 above, this business has been 100% reinsured by Cavello Bay with effect from 31 December 2016, and therefore RSAI's current net liability in respect of the Transferring Business is nil.
- 4.12 As at 31 December 2017, on a UK GAAP basis, the total assets and the total liabilities of RSAI amounted to £24,476 million and £16,502 million¹³ respectively, giving net assets of £7,974 million. The net assets represent the capital of the company under UK GAAP (it should be noted that this is not the same as the own funds available to meet the solvency capital requirements under Solvency II).
- 4.13 As at 31 December 2017, on a UK GAAP basis, RSAI held investment assets¹⁴ valued at £17,817 million. The majority of this (£12,798 million) comprised holdings in subsidiary companies. There was also £3,986 million in respect of fixed interest securities, deposits totalling £332 million, £360 million in respect of variable interest securities and £341 million in respect of land and buildings.
- 4.14 RSAI's financial strength is rated as follows:
- A (stable) by Standard & Poor's (last updated 20 June 2018)
 - A2 (stable outlook) by Moody's (last updated 4 April 2018).

Reinsurance

- 4.15 RSAI operates a number of reinsurance programmes, including excess, aggregate and catastrophe coverage. The intended effect of such reinsurance arrangements, when the other reinsurance arrangements within the RSA Group are taken into account, is that the RSA Group should not suffer total net insurance losses beyond the RSA Group's risk appetite in any one year.

⁹ Based on RSAI's Annual Report as at 31 December 2017, Note 29.

¹⁰ Based on RSAI's Annual Report as at 31 December 2017, Note 28.

¹¹ Based on RSAI's Annual Report as at 31 December 2017, Note 20.

¹² Based on RSAI's Annual Report as at 31 December 2017, Note 19.

¹³ Based on RSAI's Annual Report as at 31 December 2017.

¹⁴ Based on RSAI's Annual Report as at 31 December 2017.

- 4.16 Reinsurance programmes cover each of RSAI's and the RSA Group's main business areas including UK and international property (including catastrophe cover), construction and engineering, professional indemnity and directors & officers, surety, marine, motor, casualty and personal accident.
- 4.17 The RSA Group purchases significant catastrophe cover on a central basis, with individual entities within the RSA Group permitted to purchase additional reinsurance cover to meet local risk appetite. All catastrophe reinsurance is placed with reinsurers with a Standard & Poor's credit rating of A- or better.
- 4.18 The 2015 reinsurance programme included a Group Volatility Cover ("GVC"), designed to protect against aggregate losses (i.e. to reduce the Group's net exposure to multiple, moderate losses) but which was also available as a top-most layer on the catastrophe reinsurance programme in years where the aggregate protection is not used. This cover was placed on a three-year term ending 31 December 2017. A refreshed GVC was placed at 1 January 2018, with cover again lasting three years, until 31 December 2020. The deductible for the new cover has been slightly increased, reflecting increases in the exchange rate/exposure.
- 4.19 The RSA Group has a number of external reinsurers providing the reinsurance protections described above. As at 31 December 2017, the major external reinsurers were Berkshire Hathaway, Inc., Talanx, and Lloyd's of London (as well as to Enstar through its reinsurance of the Transferring Business).

Intra-group reinsurance

- 4.20 Currently within RSAI, intra-group inwards reinsurance contracts exist between either certain subsidiaries, which are reinsured to RSAI, or branches, which are reinsured to Royal & Sun Alliance Reinsurance Limited ("RSA Re"). The amount of reinsurance from RSAI branches to RSA Re has reduced markedly in recent years and is now relatively small. In the case of specific reinsurance agreements, RSA Re is used as a common carrier for both subsidiaries and branches and, in each case, within a "self-retention" programme managed by the RSA Group reinsurance team. Exceptions to the 'self-retention' programme are intra-group reinsurance agreements put in place for capital purposes (e.g. Irish Adverse Development Cover ("ADC")) or fronting purposes (e.g. Global Network).
- 4.21 RSA Re provides a reinsurance function for the international insurance activities of the RSA Group entities and the Global Network partners (Strategic Network Partners), selected insurers that work with the RSA Group. RSA Re also provides local coverage for those parts of the world where the RSA Group does not have approval to write business. The Global Network facilitates the fronting of risks by the RSA Group entities through servicing offices (RSA Group entities or external Strategic Network Partners) via licences to operate in the relevant territory. As of November 2017, the Global Network covered 180 territories worldwide through 36 producing offices. The Strategic Network Partners pay a fee to use the network. Membership of the Global Network enables the external partners to offer wider coverage to their clients. Most of the business written relates to global insurance programmes for multinational entities. The Global Network Team undertake relationship management and business development, with the Central Accounting Unit ("CAU"), a dedicated team based in Liverpool, undertaking reconciliation of intra-group insurance/reinsurance activity, financial reporting for RSA Re, and efficient cash-flow. RSA Re acts as the reinsurer between the producing office (the legal entity that ultimately holds the risk, predominantly RSAI, and the servicing office (the legal entity that fronts the risk). The whole of the gross premiums are retroceded, although in a few instances a 2% reinsurance commission is added. RSA Re has a net nil retention in respect of risk. Management of the treaties has been outsourced to RSAI (CAU and RSA Group Reinsurance).

Risks and risk appetite

- 4.22 The risk appetite of an organisation is the level of risk that the board and management of the organisation are willing to accept to achieve the organisation's strategic objectives.
- 4.23 RSAI's principal risks and uncertainties are integrated within and managed together with the principal risks of the RSA Group. The Board of RSAIG approves the risk appetite statements and risk tolerances for the RSA Group as a whole and for its members. RSAI has adopted the RSA Group's risk management system, reflecting the close alignment between the RSAI's risk strategy and risk appetite with that of the RSA Group

4.24 The directors of RSAI review annually the appropriateness and effectiveness for RSAI of the RSA Group's risk management system. Day-to-day oversight of RSAI's risk management system has been delegated to the RSA Group Chief Risk Officer (who is also an RSAI Director).

4.25 For the purposes of managing its risks, RSAIG classifies risk into the following categories:

- Insurance risk (which it further subdivides between Underwriting, Claims and Reinsurance risk and Reserve risk);
- Credit risk;
- Market risk;
- Liquidity risk;
- Operational risk (including both Reputational and Strategic risk); and
- Other material risks (including Pension risk).

Insurance risk

4.26 The material risks within this category are as follows:

- **Catastrophe Risk:** the risk that a single event or series of events of major magnitude, usually over a short period, leads to a significant increase in actual claims compared to total expected claims. Losses can arise from either natural perils, for example hurricane, windstorm, flood and earthquake, or from man-made perils, for example industrial accident.
- **Pricing Risk:** the risk that portfolio pricing strategies, monitoring and rating are insufficient to generate sufficient returns in key portfolios both to maintain profitability and to pay claims.
- **Reserving Risk:** the risk that
 - Case reserves are insufficient, untimely or inaccurate, leading to unforeseen adverse development;
 - More claims are reported in future than anticipated;
 - Legislative changes have a retrospective effect on claim settlements.
- **Underwriting Risk Selection:** the risk that claims arising on exposures after the valuation date are higher (or lower) than assumed in the pricing other than due to catastrophes. This can arise as the result of bad experience, third party interventions, ineffective portfolio management, poor pricing, poor risk selection or failure to underwrite effectively.
- **Claims Management Risk:** Financial losses through ineffective claims management processes, due to management information or process deficiencies.

4.27 RSAI manages these risks through its underwriting strategy, through adequate reinsurance arrangements and through proactive claims handling as follows:

- The underwriting strategy aims to ensure that the underwritten risks are well diversified in terms of type and amount of risk, industry and geography in order to ensure that RSAI is not exposed to a concentration of risk that would result in a volatile insurance result;
- The reinsurance arrangements in place include proportional, excess of loss, stop loss, catastrophe and adverse development coverage. The effect of such reinsurance arrangements is designed so that RSAI should not suffer losses beyond RSAI's risk appetite in any year (e.g. the "1 in 200" standard for catastrophe risk);

- The RSA Group has a Group Reserving Committee that monitors the decisions and judgements made by the business units as to the level of reserves recommended and makes the final decision on the reserves to be included within the financial statements. In forming its collective judgement, the Committee considers the following information:
 - An actuarial indication of ultimate losses together with an assessment of risks and possible favourable or adverse developments that may not have been fully reflected in calculating these indications;
 - The views of internal peer reviewers of the reserves and of other parties, including actuaries, legal counsel, risk directors, underwriters and claims managers; and
 - How previous actuarial indications have developed.

4.28 At the end of 2017 the following particular risks were considered by the Group Reserving Committee:

- The possibility of future legislative change having retrospective effect on open claims;
- Changes in claims settlement procedures potentially leading to future claims payment patterns differing from historical experience;
- The possibility of new types of claim, such as disease claims, emerging from business written several years ago;
- General uncertainty in the claims environment;
- The emergence of latent exposures such as asbestos;
- The outcome of litigation on claims received; and
- Failure to recover reinsurance and unanticipated changes in claims inflation.

Credit risk

4.29 The material risks within this category are as follows:

- **Counterparty Risk:** the risk that a counterparty fails to fulfil its contractual obligations and/or fails to do so in a timely manner. This includes all types of counterparties such as agents, brokers, reinsurers and other third parties.
- **Credit Concentration Risk:** the risk created by uneven distributions of exposure to counterparties, single-name or related entity credit concentration, and/or in industry and/or services sectors and/or geographical regions.

4.30 Management of Credit risk within the RSA Group is divided into three key areas, which are governed by separate policies:

- **Reinsurance:** this aspect is managed by the RSA Group Reinsurance Credit Committee. It maintains a list of approved reinsurance counterparties, largely determined by financial strength rating, and monitors diversification of the programme and the level of collateral provided.
- **Investments:** covered under Market risk in paragraphs 4.31-4.34 below.
- **Insurance Operations:** actively managed by the Credit Risk committees within each business, including RSAI.

Market risk

4.31 The material risks within this category are as follows:

- **Interest Rate Risk:** The fair value of the Group's portfolio of fixed income securities is inversely correlated to changes in market interest rates. Thus, were interest rates to fall, the fair value of the portfolio would tend to rise and vice versa.
- **Equity Price Risk:** The Group's portfolio of equity securities is subject to equity risk arising from changes in market price. Thus, were equity values to rise, so too would the fair value of its portfolio and vice versa.

- **Property Price Risk:** The Group's portfolio of properties is subject to property price risk arising from changes in the market value of properties. Thus, were property values to fall, so too would the fair value of the portfolio and vice versa.
- **Currency Risk:** The Group operates in a number of countries. Accordingly, its net assets are subject to foreign exchange rate movements. The Group's primary foreign currency exposures are to the Danish Krone, Euro, Canadian Dollar and the Swedish Krona. Thus, were the value of Sterling to strengthen relative to these other currencies, the value of non-Sterling net assets would decline when translated into Sterling and consolidated, and vice versa.

4.32 To the extent that assets and liabilities are matched by currency, Currency risk is mitigated by the equivalent sub-risk within insurance risk. However, the value of the liabilities are, in general, likely to be less responsive to movements in interest rates and values of equity and property, which means that such movements could adversely affect the financial position of RSAI.

4.33 Exposures are controlled by the setting of investment limits, currency hedging of surplus within the RSA Group, and managing asset-liability matching in line with RSAI's risk appetite. The RSA Group Investment Committee oversees RSAI's investment strategy and sets appropriate risk limits to ensure that no significant concentrations to individual companies or sectors arise.

4.34 RSAI is also conscious of the market risks arising from Brexit.

Liquidity risk

4.35 Liquidity risk is the risk of RSAI being unable to meet its cash outflows without recourse to planned contingent funding. Liquidity is managed such that RSAI maintains a level of cash or cash equivalents or highly liquid assets sufficient to meet its liabilities as they fall due based on actuarial assessment and allowing for incidents. Contingency funding plans are prepared and monitored to ensure that these minimum levels are met even in stress conditions.

Operational risk

4.36 The material risks within this category are as follows:

- **Programme Transformation Change Risk:** the risk that a major project, critical to strategic business objectives, runs behind schedule and/or incurs additional unbudgeted costs. Additional strain would be placed on the business were key "Business as Usual" staff to be enrolled on projects, resulting in work backlogs, untimely turnaround/response times, staff stress, pressure from increased workloads, etc.
- **Legal / Legislative Non-Compliance Risk:** the risk that a member of the RSA Group
 - incorrectly interprets the law or legislation and/or erroneously excludes crucial terms and conditions (from non-insurance policy contracts) leading to minor sanctions, negative reputational consequences and/or change in business practices/decisions;
 - fails to comply with changes in legislation, laws, supervisory directives, market directives, accounting practices, taxation requirements, or other requirements issued by relevant authorities within the prescribed time;
 - makes or receives bribes or inducements in order to secure business or opportunities, acting in a way considered anti-competitive.
- **Inappropriate Underwriting:** the risk that a member of the RSA Group fails to exercise appropriate levels of oversight on sales practices being adopted by individuals or related entities authorised to represent the firm or distribute its products and services directly to the market.
- **Theft or Corruption of Data:** the risk that an external party attacks the IT systems of the RSA Group with malicious intent or that a member of the RSA Group loses or discloses customer records / personal details as a result of staff negligence or loss of mobile media devices.

- **Inaccurate or incomplete data entry / processing from End User Computer Application:** the risk that errors in data input or data systems, or inaccuracies in the information provided to the reserving and claims teams, result in a significant misstatement of reserves or material mispricing.
- **Regulatory Breach:** the risk that regulatory breaches or failures, such as incorrect licensing or permissions, cause detriment to customers, clients or significant trading partners.
- **Business Interruption:** the risk of an event occurring that causes an interruption in the business, such as the failure of critical work systems, a natural disaster, war, riots, terrorism, an explosion, vandalism, social unrest, fire, etc.
- **Third Party Management:** the risk that a member of the RSA Group fails to manage, monitor and assess third parties so that poor performance or service is able to occur that affects customers and/or results in breaches of rules. In the worst cases, this can lead to business interruption, regulatory or legislative fines, financial loss or reputational damage.

- 4.37 RSAI manages operational risk using a range of techniques to identify, monitor and mitigate its operational risk in accordance with the RSA Group's risk appetite. These tools include Risk and Control Self Assessments, Key Risk Indicators (e.g. fraud and service indicators), Scenario Analyses and Loss Reporting. In addition, the RSA Group has developed a number of contingency plans, including Incident Management and Business Continuity Plans. Quantitative analysis of operational risk exposures material to RSAI is used to inform decisions on the overall amount of capital and the adequacy of contingency arrangements.
- 4.38 The RSA Group's External Communications teams keep under constant review the threats to RSAI's reputation, both internal and external, and the Risk function works with them to promote a culture of responsibility from front line businesses to the Board. The tools used include a reputational risk register, clear and simple processes, training, external threat and perception monitoring and crisis management plans.

Other material risks

- 4.39 The only other material risk identified by the RSA Group is Pension risk. This covers the risk of the financial position of the Group's defined benefit pension schemes deteriorating with a consequential adverse impact on the capital strength of the Group and/or an increase in the required level of deficit funding payable by the Group to the schemes.
- 4.40 Roughly 95% of the pension assets and liabilities (about £7.6 billion¹⁵) relate specifically to the UK defined benefit schemes. These were closed to new entrants in 2002, and two of these schemes in the UK have been closed to future accruals since March 2017.
- 4.41 The funding position of these pension schemes is sensitive to the assumptions made periodically (including inflation, interest rate, investment return and mortality) to determine their long-term liabilities relative to the corresponding market value of their assets. In particular, the financial position of the RSAI pension fund is highly sensitive to changes in bond yields, and would also be impacted by changes in equity markets and in expected longevity.

Capital Policy

- 4.42 The capital policy for the RSA Group is defined by the RSAIG Board and manifests itself through the capital adequacy objectives contained in the business plans of the member entities, including risk-adjusted returns on capital, and through detailed risk limits. The business plans cover a three-year time horizon.
- 4.43 In general, the capital policy of the RSA Group is for its member entities to maintain sufficient capital, which comprises shareholders' equity and subordinated loan capital, to meet their plans and objectives. This represents sufficient surpluses for both regulatory and economic capital, as well as sufficient capital to support the RSA Group's aim of maintaining 'A' ratings. To assist in managing their capital position, the RSA Group and its member entities have each set internal target coverage ratios for each of the principal capital measures.

¹⁵ In the context of this Report I define 1 billion as being equal to 1,000 million.

- 4.44 The RSA Group's capital assessment (and that of RSAI) is focused on both the SCR and its own assessment of the amounts of capital it needs to hold in order to meet its obligations, given its risk appetite. Both the SCR and the own assessment of required capital are calculated using the RSA Group Internal Model (which received regulatory approval in December 2015). This internal model has been integrated into the RSA Group's business processes and into those of its members, including RSAI, and is thus used to enhance the management throughout the RSA Group.
- 4.45 As per paragraph 3.16 above, the insurance entities within the RSA Group, including RSAI, are each required to conduct an ORSA, which includes the own assessment of required capital described in the preceding paragraph. RSAI defines its ORSA as a series of inter-related activities by which it establishes:
- The quantity and quality of the risks it seeks to assume;
 - The level of capital required to support those risks; and
 - The actions it will take to achieve and maintain the desired level of risk and capital.
- 4.46 In practice, the inter-related activities that together form the ORSA are carried out at different times of the year as part of an annual cycle, supplemented by ad hoc assessments of the impact of external events and developments, and of internal business proposals.
- 4.47 Papers are presented to the Board of RSAI throughout the year, dealing with the individual elements that comprise the ORSA. The information contained in those papers and the associated decisions taken are summarised in an annual ORSA report.
- 4.48 In this Report, I refer to the ratio of the actual capital that the entity under consideration holds to the regulatory solvency capital requirement as the "Capital Cover Ratio". As at 31 December 2017, RSAI held eligible own funds available to meet the MCR and the SCR totalling £2,805 million and £3,365 million respectively. The MCR for RSAI as at 31 December 2017 was £641 million, giving a Capital Cover Ratio for MCR of 437%. The SCR for RSAI as at 31 December 2016 was £1,804 million, giving a Capital Cover Ratio for SCR of 187%¹⁶.

Conduct Risk

- 4.49 I have been told that the RSA Group is committed to meeting at all times all regulatory and relevant legislative requirements and obligations, through a system of policies and procedures, reporting and controls, to ensure that conduct risk is mitigated and a strong conduct risk culture is embedded throughout the RSA Group. This appetite is cascaded down to all areas of the business.
- 4.50 RSAI has set up a Conduct Framework in order to ensure that fair outcomes are delivered to customers. The key components of this framework are culture, governance, management information, and assurances.
- 4.51 Staff in the UK must complete mandatory conduct training, with managers being provided with guidance on applying good conduct principles. Staff surveys are carried out to measure the success with which key conduct messages are being received by staff. Staff rewards are partly based on the performance against customer objectives.
- 4.52 There are processes in place to ensure that the fair treatment of customers is achieved, including regular monitoring and rectification of any shortcomings that are identified.
- 4.53 The RSAIG Board has ultimate responsibility for ensuring that conduct objectives are met within the UK businesses of the RSA Group. This is achieved via the newly formed Customer Committee, UK Executive Committee and Group Board Risk Committee oversight and challenge. A governance structure has been implemented to facilitate this and to embed the Conduct Framework throughout RSA's UK business.

¹⁶ These figures were taken from QRT S.23.01.01, shown on page 30, Appendix 8 of the 2017 Solvency and Financial Condition Report for RSAIG.

Brexit

- 4.54 RSAI currently writes business within the EU but outside the UK, both on local paper through branch offices in Belgium, France, Germany, the Netherlands and Spain, and on a Freedom of Services basis. It has a strategic plan to develop further this business. To enable it to deliver its strategic plan, post-Brexit, it has established a new entity in Luxembourg (RSA Luxembourg S.A. or "RSAL"), into which RSAI's non-UK EU business was transferred, via a Part VII transfer, with effect from 1 January 2019. There is no overlap between the RSAI Transferring Business and RSAI's non-UK EU business and none of the RSAI Transferring Business was included in this transfer to RSAL.
- 4.55 I note in passing that I have met with the independent expert who has been appointed in respect of the Part VII transfer to RSAL and we have discussed, in broad terms, our respective findings in respect of RSAI. Nothing emerged from those discussions that has caused me concern or has prompted me to revise my findings or conclusions as set out in this Report.
- 4.56 I further understand that RSA Insurance Ireland DAC, which is a member of the RSA Group, currently writes some business in Northern Ireland (i.e. within the UK). I have been informed by the RSA Group that it is considering its options to ensure that the RSA Group can continue, post Brexit, to write business in Northern Ireland. I have been further informed that none of the options that are being considered involves the transfer of the business already written by RSA Insurance Ireland DAC in Northern Ireland to another RSA Group entity.

MIC

Background

- 4.57 MIC is an insurance company, registered as a private limited company in England and Wales (registered number 00014809) under the Companies Act 2006. MIC's immediate parent company is RSAI. RSAIG is the ultimate holding company of MIC.
- 4.58 MIC's issued and fully paid share capital as at 31 December 2017 was made up of 1,304,945 ordinary shares of £12.50 each¹⁷.

Business Written

- 4.59 MIC is the RSA Group vehicle for the writing of specialty insurance business and is also authorised to write US Surplus Lines policies. Gross premiums written during 2017 totalled £37.7 million, 51% of which related to Marine, Aviation and Transport and 49% to Renewable Energy. This was wholly US Surplus Lines business.
- 4.60 With effect from 1 January 2012, MIC entered into an excess of loss agreement and a quota share arrangement with RSAI under which the insurance risk of MIC's business was transferred to RSAI. The excess of loss reinsurance covers business written pre-2012, while the 100% quota share arrangement applies to business written since the beginning of 2012. That agreement and arrangement remain in place.

Key financial information

- 4.61 As at 31 December 2017, on a UK GAAP basis, the gross outstanding claims reserves¹⁸ within MIC were £16.2 million. In addition, as at 31 December 2017, MIC held a gross provision for unearned premiums¹⁹ of £23.2 million. Net of reinsurance, these amounts were both nil.
- 4.62 MIC management considers that the UK GAAP booked reserves remain reasonable and within a range of best estimates for MIC.

¹⁷ Based on MIC's Annual Report as at 31 December 2017, note 18.

¹⁸ Based on MIC's Annual Report as at 31 December 2017, page 13.

¹⁹ Based on MIC's Annual Report as at 31 December 2017, page 13.

- 4.63 The outstanding claims reserves shown in MIC's balance sheet within its Report & Accounts as at 31 December 2017 exclude allowance for the MIC Transferring Business, the assets and liabilities relating to which are shown separately.
- 4.64 As at 31 December 2017, MIC booked reserves, gross of reinsurance, in respect of the MIC Transferring Business equal to £73.0 million. As this business is in run-off, all of the reserves relate to outstanding claims and there are no premium provisions. The equivalent booked reserves for MIC, net of outwards reinsurance (but gross of intra-group reinsurance), were £51.2 million.
- 4.65 The booked reserves in respect of the MIC Transferring Business are the equivalent of 65.0% of the total gross technical provisions (including those relating to the MIC Transferring Business) and 81.8% of total gross outstanding claims reserves (including those relating to the MIC Transferring Business) as at 31 December 2017.
- 4.66 As noted in paragraph 4.60 above, all of MIC's business has been 100% reinsured by RSAI with effect from 1 January 2012, and therefore MIC's current net liability in respect of the MIC Transferring Business is nil.
- 4.67 As at 31 December 2017, on a UK GAAP basis, the total assets and the total liabilities of MIC amounted to £180.4 million and £130.7 million respectively²⁰, giving net assets of £49.7 million. The net assets represent the capital of the company under UK GAAP (it should be noted that this is not the same as the own funds available to meet the solvency requirements under Solvency II).
- 4.68 As at 31 December 2017, on a UK GAAP basis, MIC held investment assets²¹ valued at £30.1 million, of which 67% was invested in gilts and the remainder in corporate bonds. Of the £30.1 million of debt securities within MIC's balance sheet, 81% was rated AA and a further 17% was rated A.
- 4.69 As a result of its surplus lines authorisations the company maintains a US Surplus Lines trust fund ("SLTF"). As at 31 December 2017, the SLTF had assets of US\$7.7 million²².

Reinsurance

- 4.70 The main reinsurance protection for MIC is the 100% quota share arrangement on all business written since the beginning of 2012, plus the excess of loss cover that applies to all earlier business. These covers apply after application of any other outwards insurance covers provided by third party reinsurers.

Risk management

- 4.71 From the perspective of MIC, the principal risks and uncertainties are integrated within the principal risks of the RSA Group and are not managed separately. The principal risks and uncertainties of the RSA Group, which include those of the UK business, and hence MIC, are set out in paragraphs 4.22-4.41 above. The most significant risks for MIC are:
- **Market risk:** this is the risk of changes in market rates, currency exchange rates, equity prices, etc., adversely affecting the value of assets. The principal control is the application of investment limits in line with MIC's risk appetite statement.
 - **Credit risk:** this is the risk that invested assets fail to deliver contractual payments. The principal control is the application of limits on credit risk and concentrations of assets in line with MIC's risk appetite statement. The investment portfolio is almost wholly in listed assets.
 - **Reinsurance default risk:** the risk of RSAI defaulting on its 100% reinsurance of MIC's insurance liabilities.

20 Based on MIC's Annual Report as at 31 December 2017.

21 Based on MIC's Annual Report as at 31 December 2017.

22 National Association of Insurance Commissioners' Quarterly Listing of Alien Insurers April 2018.

Conduct Risk

4.72 MIC has no employees. All administration relating to MIC business, including policy servicing, is currently performed by RSAI staff on an outsourced basis. I have no reason to believe that MIC policies are administered in general any differently from RSAI policies or that the policyholders of MIC and claimants and their representatives relating to MIC policies are treated any differently from their RSAI counterparts. However, I note that the FCA's conduct of business rules include an exemption for insurers where the customer is introduced by an intermediary that is not based in the UK and the customer is not habitually resident in an EEA State. The business activities of MIC fall within this exemption.

Capital

4.73 As at 31 December 2017, MIC held eligible own funds available to meet both the MCR and the SCR totalling £48.1 million. The MCR for MIC as at 31 December 2017 was £3.2 million, giving a Capital Cover Ratio for MCR of 1,481%. The SCR for MIC as at 31 December 2017 was £8.9 million, giving a Capital Cover Ratio for SCR of 541%²³.

Brexit

4.74 All business currently being written by MIC relates only to US exposures. The only business within MIC that relates to non-UK EU risks is in run-off and is contained within the MIC Transferring Business. Assuming that the Scheme goes ahead, there will be no non-UK EU risks remaining within MIC shortly after the date of Brexit. Therefore, it is not expected that MIC will be affected by Brexit.

THE ENSTAR GROUP

4.75 The Enstar Group comprises EGL and its direct and indirect subsidiaries. While EGL is not explicitly a party to this Scheme, certain members of the Enstar Group are parties to the Scheme and others are implicitly involved. Therefore, it is appropriate to consider here the Enstar Group as a whole and then to consider in detail specific members of the Enstar Group, those being Mercantile and Cavello Bay.

4.76 The parent company in the Enstar Group is EGL. I have attached in Appendix C a graphical representation of the composition of the relevant parts of the Enstar Group.

4.77 The core of the Enstar Group's business is the acquisition and management of legacy insurance risk, primarily relating to Property & Casualty business. In this segment, the Enstar Group acquires discontinued insurance portfolios from on-going companies and also entire companies.

4.78 By acquiring multiple run-off portfolios, the Enstar Group can consolidate risks and thus should be able to manage them more efficiently and effectively than their erstwhile carriers.

Risk management strategy

4.79 A common Risk Management Framework ("RMF") operates across the Enstar Group, subject to each entity setting its own risk appetite. The RMF encourages good practice through a strong risk management culture across all operations.

4.80 Within the RMF, the risk management function is an Enstar Group function, with each entity having a designated team responsible for that entity and reporting to that entity's management and Board.

4.81 The main responsibilities of the risk management function are to:

- Assist the EGL Board in maintaining an appropriate risk management culture throughout the Enstar Group.
- Maintain an infrastructure for risk management processes for identifying, assessing, managing and monitoring risk for the Enstar Group, both in aggregate and at an entity level.

²³ These figures were taken from QRT S.23.01.01, shown on page 54, Appendix 8 of the 2017 Solvency and Financial Condition Report for RSAIG.

- Integrate risk management with strategy setting and business planning and provide guidance and direction to the Group and subsidiary Boards on risk management matters.
 - Develop, maintain and report on the risk appetite framework of the Enstar Group and of its individual members.
 - Review and oversee the risk reporting process, ensuring that appropriate information is presented to senior management and the boards of EGL and of its subsidiaries.
 - Perform (in conjunction with the appropriate executives) the ORSA process for the Enstar Group, both at a group level (Group Solvency Self-Assessment or “GSSA”) and at an entity level.
- 4.82 The risk and control registers are maintained and managed in the risk management software system (which is used throughout the Enstar Group). The risk management software system acts as an interface between the business functions (with risk and control owners), the risk management function and the entity Boards and senior managers. The risk management software system facilitates the Enstar Group to identify, measure, monitor, manage and report, on a quarterly basis, the risks on an individual and aggregated level.
- 4.83 A feedback loop operates such that conclusions and actions (which are all recorded and shared through the GSSA/ORSA process and risk reporting) ensure that risk management attention can be directed to improvements or remediation.
- 4.84 The risk management software system and risk management processes therefore allow the risk management function:
- to be proactive and consistent in its approach to the identification, assessment and management of risks across operations;
 - to ensure risks are managed within the limits of the entity’s prescribed risk appetite; and
 - to notify the relevant governance body where events might have breached, or are likely to breach, risk appetite.
- 4.85 The EGL Board reviews the risk and solvency position of the Enstar Group at least annually at both a group and subsidiary level, as well as when a significant development necessitates a further review for a specific entity or transaction. The EGL Board also considers, on a quarterly basis, whether or not there has been a material change that may require additional analysis and explanation (and remediation if necessary).

Investment policy

- 4.86 The Enstar Investment Management team (“EIM”), a member of the Enstar Group incorporated in Bermuda, provides investment management services to the Enstar Group, which includes oversight of third party investment managers and management of internal portfolios. EIM works with the Enstar Group’s senior executives, investment committees and local boards to establish an investment policy framework for the Enstar Group and to set asset allocations for each relevant Enstar Group entity and for the Enstar Group in aggregate.
- 4.87 The objectives of the investment policy are to:
- Match the cash-flow and currency of the investments with the liability structure of each entity so that the entity has sufficient liquidity to settle claims, complete commutations and pay its debts as and when they are due.
 - Provide a quality return on the investment portfolio within prescribed risk parameters.
 - Give guidance and boundaries to the investment decision-making process.

Conduct risk policy

- 4.88 The Enstar Group has a Code of Conduct, which provides an ethical and legal framework for business practices and conduct standards to which all Group employees, officers and directors must adhere at all times. It is the Enstar Group’s policy to maintain a high level of professional and ethical standards in the conduct of its business affairs. The Enstar Group places great importance upon its reputation for honesty, integrity and high ethical standards.

MERCANTILE

Background

- 4.89 Mercantile is an insurance company, registered as a private limited company in England and Wales (registered number 01500302) under the Companies Act 2006. Its immediate parent company is Kenmare Holdings Ltd. EGL is the ultimate holding company of Mercantile. Both Kenmare Holdings Ltd and EGL are incorporated in Bermuda.
- 4.90 Mercantile's issued and fully paid share capital as at 31 December 2017 was made up of 227 million ordinary A shares of US\$0.015 each plus 2 million B deferred shares of US\$1.50 each²⁴.
- 4.91 Mercantile actively wrote business between 1982 and 1987, since when it has accepted no new business. Mercantile revoked its underwriting licence in 1995. In 2016, it applied to the Court for approval of a Part VII transfer of all assets and liabilities (other than assets totalling US\$4 million) to River Thames Insurance Company Limited. That application was sanctioned with effect from 7 April 2017, since when Mercantile no longer has any remaining insurance liabilities. However, it remains authorised to carry out contracts of insurance and is capitalised in accordance with UK minimum capital requirements. With effect from 30 July 2018, the PRA approved Mercantile's application to vary its permission to effect contracts of insurance and thereby to receive the Transferring Business in accordance with the Scheme.
- 4.92 It is authorised to write the following classes of business: 1 (Accident), 2 (Sickness), 4 (Railway rolling stock), 5 (Aircraft), 6 (Ships), 7 (Goods in transit), 8 (Fire & natural forces), 9 (Damage to property), 11 (Aircraft liability), 12 (Liability for ships), 13 (General liability), 14 (Credit), 15 (Suretyship), 16 (Miscellaneous financial loss) and 17 (Legal expenses).
- 4.93 Mercantile has received the necessary approval from the International Insurers Department ("IID") of the NAIC for it to establish a US SLTF, subject to it holding assets valued at a minimum of \$17,610,000 (to be reviewed annually) and to EGL providing a Deed of Guarantee under which EGL would make good any shortfall in the required security in excess of the value of the assets held in the SLTF.

Risks and Risk Appetite

- 4.94 Mercantile operates within the Enstar Group RMF.
- 4.95 Mercantile's risk profile is expected to be, post-Scheme, very similar to that of the other UK-regulated non-life run-off entities within the Enstar Group.

Insurance risk

- 4.96 Mercantile will not be writing any new business so it is not exposed to underwriting risk. However, it will be exposed to reserving risk, which will be the dominant risk category, but which will be 75% reinsured. The company has a medium appetite to the retained reserving risk, to the extent that booked reserves meet or exceed those estimated using appropriate actuarial methodology.

Investment risk

- 4.97 Mercantile has identified that it will face investment risk in two principal areas:
- investment of Mercantile's own assets; and
 - investment of the reinsurance collateral account (as described in more detail below, under the Reinsurance Agreement Cavello Bay is required to maintain a collateral account)
- 4.98 Investment of Mercantile's own assets will be in accordance with Mercantile's investment guidelines. Performance and adherence to those guidelines will be monitored by the Mercantile Board, which will receive quarterly investment reports. Any incidents of non-compliance will be investigated and rectified.

²⁴ Based on Mercantile's Annual Report as at 31 December 2017, note 11.

- 4.99 Investment of the reinsurance collateral account will be the responsibility of the reinsurer, in accordance with the applicable investment guidelines, as agreed between Mercantile and the reinsurer. Quarterly investment reports, to be provided to the Mercantile Board, will confirm how investments have been managed and any incidents of non-compliance with the applicable guidelines will be investigated and rectified. A process has been established to re-set, post-Scheme, the collateral account on a quarterly and annual basis.

Reinsurer credit risk

- 4.100 The key counterparty under the Reinsurance Agreement is the reinsurer, i.e. Cavello Bay. As noted above, the Reinsurance Agreement with Cavello Bay includes a collateral account. In addition, the performance of Cavello Bay is guaranteed by EGL. Post the Effective Date, the collateral will be set at a level such that it is sufficient to ensure Mercantile's credit risk (under the Standard Formula for Solvency II and over a one-year time horizon) will be zero at all times.
- 4.101 There remain certain credit risks associated with third party reinsurers relating to the liability retained by Mercantile, and with counterparties managing cash holdings.

Asset-liability management risk

- 4.102 Mercantile has identified asset-liability management risk as a low risk. It aims to align the duration of its investment portfolio to the estimated reserve settlement patterns for the retained proportion of liabilities. With regard to funds within the collateral account, the asset-liability matching is the obligation of the reinsurer.
- 4.103 Currently the reporting currency for Mercantile is USD, and the investments currently held within Mercantile are USD denominated. I have been informed by Enstar that, ahead of the Effective Date, it intends to change the reporting currency for Mercantile to GBP, with all solvency and surplus capital being held in GBP denominated investments. This will greatly negate any foreign exchange currency risk within Mercantile.

Liquidity risk

- 4.104 It has been identified that liquidity risk will be a low order risk for Mercantile because it relates to claims settlements and associated claims costs for which 75% of the risk will have been transferred under the Reinsurance Agreement with Cavello Bay and for which a collateral account will have been established. Additionally, Mercantile will keep sufficient short-term liquidity to meet its cash demands.

Operational risk

- 4.105 Mercantile will mitigate its operational risk through implemented policies and procedures and the robust system of internal control and compliance processes. This includes but is not limited to business continuity planning, information security, financial reporting controls and material third-party vendor and outsourcing management. Quarterly attestation of both risks and controls is required and incidents or exceptions or breaches are reported through the Magique system. There is a separate but parallel process for the IT controls. The summary of risk and control operations is provided to the Board in a risk management report each quarter. This information is also included in the ORSA, which is produced at least annually. This is in line with the Enstar Operational Risk framework, which is generally applicable throughout the Enstar Group.

Risks arising from outsourcing

- 4.106 Mercantile's own risk and control systems will include those services performed by third party providers on its behalf. Outsource risk will be monitored by the Client Services Director (or such other individual(s) appointed by the Mercantile Board) who will obtain a quarterly confirmation by the service provider and further confirmation by the business function heads that outsourced services meet the required standards.
- 4.107 I emphasise that the above risk profile for Mercantile is post-Scheme. Pre-Scheme Mercantile has no insurance liabilities and its risks primarily relate to the retained capital.

Capital Policy

- 4.108 Mercantile will at all times comply with applicable regulatory solvency requirements. It will have access to the capital modelling team within Enstar (EU) Limited ("EEUL"), which comprises suitably experienced qualified actuaries who comply with relevant professional standards.

Conduct Risk

- 4.109 As explained in paragraph 4.88 above, the Enstar Group has a Code of Conduct to which all Group employees, officers and directors, including those Group employees who provide services on behalf of Mercantile, must adhere at all times.
- 4.110 Post-Scheme, all claims relating to Mercantile's business will be dealt with by EEUL, which is a UK registered member of the Enstar Group specialising in providing insurance claims and administrative services.

Current Plans including Brexit

- 4.111 Currently, Mercantile's only plans of significance relate entirely to the Scheme. No other business transfers are presently anticipated although it is possible that in the future others might be undertaken. However, any such transfers will be subject to appropriate scrutiny prior to being approved. Such scrutiny will consider, among other things, the ongoing security of both benefits and service levels for the then current policyholders of Mercantile who, assuming that the Scheme is approved, will include the Transferring Policyholders. I have not considered further in this Report the possibility of future, but as yet unknown, business transfers into Mercantile.
- 4.112 As discussed in paragraph 3.27 above, those UK insurers that currently conduct business elsewhere in the EEA are making contingency arrangements in case, as a result of Brexit, they lose passporting rights to undertake business within the EEA. It is intended that Mercantile is used as a vehicle to accept portfolios of business in run-off; there are no plans to underwrite new risks in Mercantile. Therefore, the loss of rights post-Brexit to underwrite across the EEA will not affect Mercantile, but it could affect its ability, and that of other members of the Enstar Group in a similar situation, to accept portfolios of risks written in the EEA but outside the UK. Therefore, the Enstar Group is currently progressing the establishment of a new authorised insurer in a non-UK EEA state, in order that it has a dedicated EEA run-off entity that would be able to acquire new business and exercise passporting rights post-Brexit, in addition to its existing authorised entity in Belgium.
- 4.113 At the same time as it works towards establishing a new entity in a non-UK EEA state, the Enstar Group is also considering what additional requirements will be imposed upon Mercantile to enable it to continue to be able to conduct cross-border EEA activities as, in effect, a third country insurer.
- 4.114 In general, the ability of any UK insurer to conduct cross UK/EEA border activities will depend upon both the nature of the relevant cross-border activities and the extent to which local laws in each applicable EEA state permit such activities to be carried on by third country insurers in the absence of local authorisation. As a company in run-off, the principal activity of Mercantile in any EEA state would be the payment of local policyholders' claims. Mercantile will therefore need to comply, post-Brexit, with the local requirements (if any) for conducting such activity in each EEA state in which it has business.

4.115 The treatment of run-off activity varies under local law across the EEA. I have been told that, due to the age of the Transferring Business, it is not possible to produce a definitive list of the applicable EEA states to which each policy within the Transferring Business relates. However, there are no known non-UK EEA policyholders within the RSAI Transferring Business and only 18 known non-UK EEA policyholders within the MIC Transferring Business (although it is possible that other non-UK EEA policyholders will emerge). These policyholders are based in France, Germany, Greece, Italy, Luxembourg, Norway and the Netherlands. After working with its external advisors to understand what action (if any) needs to be taken in each EEA state in order to satisfy local requirements, the Enstar Group has established that, of these seven countries, only Germany, Greece and Norway would require the establishment of a locally authorised branch to ensure the continued payment of claims under contracts in run-off by a third country insurer/reinsurer. Within the Transferring Business, there are just five non-UK EEA policyholders who are based in those three countries, and no more than two in any one of the countries. With that in mind, it would be considered disproportionate for Mercantile to establish a branch in each of these three countries. Instead, Mercantile intends liaising with the regulators in such states if passporting rights are lost as a result of Brexit. In the event that Mercantile is nonetheless required to take steps to satisfy the relevant local requirements, Mercantile would take such steps prior to the end of any implementation/transition period on 31 December 2020 that has been agreed in principle between the UK and the EU (subject to the terms of a withdrawal agreement being finally concluded). Alternatively, Mercantile would seek to settle or commute with such policyholders, or to seek a novation of the policies to an entity with suitable authorisation and passporting rights.

CAVELLO BAY

Background

- 4.116 Cavello Bay is a Class 3B Bermuda-domiciled and regulated reinsurance company. Its immediate parent company is Kenmare Holdings Ltd. EGL is the ultimate holding company of Cavello Bay.
- 4.117 Cavello Bay's issued and fully paid share capital as at 31 December 2017 comprised 120,000 common shares of US\$1.
- 4.118 As mentioned in paragraph 1.11 above, in February 2017 Cavello Bay agreed to reinsure the RSAI Transferring Business plus RSAI's 100% reinsurance of the MIC Transferring Business, with effect from 31 December 2016. At the time of the agreement, Cavello Bay did not have the necessary permissions from the BMA to underwrite this reinsurance cover and so, pending the granting of those permissions, Fitzwilliam provided the reinsurance cover, under the Reinsurance Agreement. On 5 April 2017 the BMA gave approval to Cavello Bay for it to underwrite this reinsurance business, and the Reinsurance Agreement was novated from Fitzwilliam to Cavello Bay on 3 May 2017, together with the benefit of a premium of £797.9 million²⁵. I discuss the terms of the Reinsurance Agreement in more detail in Section 5 below.

Key financial information

- 4.119 As at 31 December 2017, apart from reinsuring the RSAI Transferring Business plus RSAI's 100% reinsurance of the MIC Transferring Business, Cavello Bay provided the following covers:
- An ADC in respect of Sussex Insurance Company, another member of the Enstar Group (during 2018, Sussex Insurance Company merged with Clarendon National Insurance Company, another member of the Enstar Group, with the latter name being retained);
 - 100% cover of a multi-line portfolio of business written by QBE Insurance Group Limited ("QBE"). The assumed liabilities (approximately US\$1,019 million gross of reinsurance, US\$447 million net of reinsurance) relate to discontinued lines of business, primarily workers' compensation, construction defect and general liability.

²⁵ Based on Cavello Bay's Annual Report as at 31 December 2017, note 3.

- 100% cover of exposures relating to certain insurance liabilities of Coca-Cola Refreshments USA Inc. (“CCR”) that had been self-insured by CCR during the period 1986-2010. This was effected by two contracts, reflecting the primary layer cover and the excess layer of the Coca-Cola risks. The primary layer was covered by StarStone National Insurance Company (“SNIC”), a member of the Enstar Group, and the excess layer by Red Re Captive Insurance Company Inc. (“Red Re”), which is CCR’s captive insurer. Cavello Bay 100% reinsures SNIC and Red Re in respect of these insurance contracts; and
- 25% cover of all workers’ compensation business written by Clear Spring Property & Casualty Company Limited (“Clear Spring”). Clear Spring, which was previously named SeaBright Insurance Company, Inc., had been a member of the Enstar Group but was sold to Delaware Life Insurance Company in January 2017, with 20% indirect equity interest in Clear Spring remaining within the Enstar Group.

4.120 In addition:

- during 2016, four Bermuda-domiciled members of the Enstar Group (Rosemont Reinsurance Limited, Chaparral International Re Limited, Electricity Producers Insurance Company (Bermuda) Limited and New Castle Reinsurance Company Limited) were merged into Cavello Bay, which thus assumed their outstanding liabilities; and
- during 2017, three Bermuda-domiciled members of the Enstar Group (Overseas Reinsurance Corporation Limited, Point Bay Insurance Limited and Inter-Ocean Reinsurance Company Limited) were merged into Cavello Bay, which thus assumed their outstanding liabilities.

4.121 As described further in paragraph 4.130 below, Cavello Bay merged with an additional Bermuda-domiciled member of the Enstar Group and also entered into a number of transactions under which it assumed additional business during 2018. Subject to regulatory approval, Cavello Bay might merge with additional Bermuda-based members of the Enstar Group during 2019, as well as continuing to assume additional portfolios where suitable opportunities arise.

4.122 As at 31 December 2017, Cavello Bay held total provisions, gross of reinsurance, in respect of outstanding claims and unallocated loss adjustment expenses (“ULAE”) totalling US\$2,074 million²⁶, with the reinsurers’ share of these reserves booked at US\$542 million. Therefore, Cavello Bay held net claims reserves as at 31 December 2017 of US\$1,532 million. As at 31 December 2017, although most of its business comprised (re)insurance portfolios in run-off, Cavello Bay held a small reserve (US\$3.6 million) in respect of unearned premiums relating to the Clear Spring reinsurance cover.

4.123 As at 31 December 2017 Cavello Bay held capital and reserves in excess of its liabilities totalling US\$1,386 million²⁷.

4.124 Cavello Bay’s assets as at 31 December 2017 included:

- Investments (US\$1,732 million – see below for details);
- Cash (including restricted cash) and cash equivalents (US\$364 million in total);
- Funds held and directly managed in respect of the QBE transaction (US\$180 million);
- Funds withheld (US\$159 million);
- 48% shareholding (US\$310 million) in KaylaRe Holdings Ltd (“KRH”), the holding company for KaylaRe Ltd, a recently established Bermuda-domiciled Class 4 insurer (since the 2017 year-end EGL has purchased the remaining 52% shareholding in KRH so that the Enstar Group now owns all of KRH);
- Amounts due from related parties (US\$103 million); and

26 Based on Cavello Bay’s Annual Report as at 31 December 2017.

27 Based on Cavello Bay’s Annual Report as at 31 December 2017.

- Other assets (US\$89 million).

4.125 87% of the investments by booked value as at 31 December 2017 comprise fixed maturity/short term and asset backed loans. Of these, 11% are rated AAA, 24% AA, 34% A, 21% BBB and 11% are unrated.

Reinsurance

4.126 Cavello Bay has not purchased any outwards reinsurance protection for the inwards reinsurance business that it has assumed. However, some outwards reinsurance contracts were attached to the inwards reinsurance business that Cavello Bay has assumed and hence Cavello Bay benefits from those covers.

Risks

4.127 Cavello Bay operates within the Enstar Group RMF. It has identified the following seven key risk areas and its approach to managing these risk areas in its Commercial Insurance Solvency Self-Assessment (“CISSA”) report for the year ending 31 December 2017, and dated 30 April 2018:

- **Strategic risk:** the risk of business decisions, improper implementation of those decisions, ability to adapt to changes in the external environment, or circumstances that are beyond Cavello Bay’s control leading to missed targets, additional costs, lost profits, etc. Strategic risk is managed within Cavello Bay by use of a strategic business planning process involving senior management and the Board of Directors, who oversee the annual business plan and review actual performance, trends, and uncertainties related to the plan. They review all inwards reinsurance opportunities, taking into account, among other things, the risk of the transaction and potential returns, the portfolio’s risk exposures, claim management practices, reserve requirements and outstanding claims, as well as risks related to integration, and they also review all other significant business initiatives as aligned with the business plan. The Enstar Group and its management teams have considerable knowledge and experience in insurance run-off, and that knowledge and experience are shared throughout the Enstar Group, including with Cavello Bay.
- **Insurance risk:** this comprises primarily reserving risk and is the risk of material unexpected changes in insurance claims reserves. While the Enstar Group actuaries use generally accepted actuarial methodologies to estimate ultimate losses and loss adjustment expenses, the nature of the underlying business (51% of net reserves as at 31 December 2017 related to asbestos exposures, with a further 21% to workers’ compensation and personal accident) is such that there is considerable uncertainty within those estimates, and material movement away from those estimates is possible.
- **Market risk:** the risk of loss resulting from underperforming investment returns, dilution of invested capital, or adverse financial market movements (such as interest rates or exchange rates). This risk can be subdivided into four primary types: interest rate risk, credit risk, equity price risk and foreign currency risk. This risk is managed in a number of ways, including: managing the portfolio in accordance with the Prudent Person Principle; use of investment guidelines; regular reviews of investment opportunities; market conditions; portfolio duration; oversight of the selection and performance of external asset managers; regular stress testing of the portfolio against known and hypothetical scenarios; established tolerance levels; and, where possible, foreign currency asset/liability matching. Although Cavello Bay (as per all regulated members of the Enstar Group) has its own separately identifiable investment portfolio, investments are primarily managed at Enstar Group level, and overseen by EGL’s Investment Committee and by the Cavello Bay Board.
- Cavello Bay manages its currency risk by matching its liabilities under insurance and reinsurance policies that are payable in foreign currencies with assets that are denominated in such currencies, subject to regulatory constraints. Where appropriate it also selectively uses foreign currency forward contracts to mitigate foreign currency risk.
- Cavello Bay’s investment strategy is dependent on the duration of its liabilities. Reserves with payouts not expected within 5 years are invested in higher yielding instruments, which might include liquid non-investment grade assets, whereas reserves with expected payouts within shorter periods are invested in investment grade corporate debt instruments, with durations matched with the liabilities.

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- The CISSA showed that the size of the investment portfolio under management was expected to increase from its level as at 31 December 2017, reflecting corporate activity that took place subsequent to the 2017 year-end (see paragraph 4.130 below). However, the market/investment risk profile was not expected to alter materially, given that the associated assets would comprise a high proportion of investment grade securities. The expanded investment portfolio would continue to be subject to the existing internal control environment and to EGL oversight.
 - **Liquidity risk:** the risk of being unable to realise investments and other assets in order to settle financial obligations when they fall due. I explained above Cavello Bay's policy of investing primarily in liquid instruments and in assets whose durations match those of the liabilities.
 - **Reinsurance credit and counterparty risk:** the risk that a reinsurance counterparty fails to fulfil its contractual obligations and/or fails to do so in a timely manner. As noted above in paragraph 4.126, Cavello Bay has itself bought no outwards reinsurance protection but it does benefit from the reinsurances attaching to both the portfolios that it has assumed under the various inwards reinsurance transactions, as well as those portfolios of businesses merged into Cavello Bay. Cavello Bay's potential exposure to this risk increased materially during 2017 through the reinsurance agreements with QBE and RSA. All ceded reinsurance placed with the top 10 reinsurers were either rated A- and above or are fully collateralised. Cavello Bay monitors bad debt quarterly as well as scrutinising any bad debt relating to acquisitions as part of its due diligence.
 - **Regulatory/reputational risk:** the risk that an act or omission by Cavello Bay, or by any of the employees of the Enstar Group that provide services on behalf of Cavello Bay, could result in damage to its reputation or loss of trust among its stakeholders. Cavello Bay, in common with the Enstar Group in general, has little appetite for reputational risk. It manages reputational risk through a focus on compliance with laws and regulations, adherence to its policies and procedures (including the Enstar Code of Conduct) and its internal controls, an established corporate governance framework and practices, and communication and engagement with stakeholders. The CISSA highlights the increasing reporting requirements and regulatory oversight by the BMA, as well as the potential impact of GDPR and other emerging data privacy laws elsewhere in the world.
 - **Operational risk:** the risk of a loss arising from inadequate or failed internal processes, or from external events, personnel, systems or third parties. Operational risk is mitigated through implemented policies and procedures and the robust system of internal control and compliance processes. This includes but is not limited to business continuity planning, information security, financial reporting controls and material third-party vendor and outsourcing management. The effectiveness of the controls is assessed quarterly, with key controls being tested at least annually.
 - **Emerging risks:** these are risks that may develop or that already exist but which are difficult to quantify, might not be fully understood and might have a high future loss potential. As they become better understood they would typically be absorbed as an element of one of the other risk categories, e.g. cyber risk, which is now tracked as an individual risk within the Operational risk category. Emerging risks are marked by a high degree of uncertainty. Examples include:
 - Brexit scenario risks
 - Possible US tax reform
 - The impact of Fintech (e.g. "blockchain" methods of doing business)
 - The impact of climate change and the decarbonisation of the global economy
 - Changes in Group Regulatory environment
 - Shortage of experience in Lloyd's Corporation with respect to Reinsurance-to-close transactions
 - Climate change
 - Pandemic
 - Terrorism/conflict.

Capital Policy

4.128 Cavello Bay will at all times comply with applicable regulatory solvency requirements. It has access to the Enstar Group's capital modelling team, which comprises suitably experienced qualified actuaries who comply with relevant professional standards.

Conduct Risk

4.129 As explained above in paragraph 4.88 above, the Enstar Group has a Code of Conduct to which all Group employees, officers and directors, including those of Cavello Bay, must adhere at all times.

Recent developments and current plans including Brexit

4.130 As detailed below, since 31 December 2017 Cavello Bay has entered into several significant transactions under which it has assumed additional business:

- In February 2018, Cavello Bay agreed to reinsure the New South Wales Vehicle Compulsory Third Party ("CTP") insurance business of an Australian subsidiary of Zurich Insurance Group Limited ("Zurich"). The assumed liabilities total roughly US\$275 million, net of reinsurance. The transfer of the CTP insurance business from Zurich to Cavello Bay, under Division 3A Part III of Australia's Insurance Act of 1973, was subsequently approved, effective from 31 December 2018.
- At the end of 2017 Enstar and Allianz SE agreed that Fitzwilliam (acting in respect of its segregated account Number 40) would 50% reinsure workers' compensation and asbestos, pollution and toxic tort business, originally assumed by San Francisco Reinsurance Company, with effect from 31 December 2017. Net of outwards reinsurance the liabilities assumed by Fitzwilliam total US\$81 million. The reinsurance contract was novated from Fitzwilliam to Cavello Bay, effective from 1 October 2018.
- On 27 December 2018, the Enstar Group announced that it had completed the acquisition of Maiden Reinsurance North American, Inc. ("MRNA"), a US domiciled insurance company. As part of the transaction, quota share reinsurance agreements that protect MRNA for underwriting years 2017 and prior, and an adverse development cover contract relating to the 2016 underwriting year, have been novated from Maiden Reinsurance Ltd (MRNA's Bermudan reinsurer) to Cavello Bay. Cavello Bay has also provided retrocession cover to Maiden Reinsurance Ltd in respect of its reinsurance of Motors Insurance Corporation. Under these novation and retrocession agreements, I am informed by the Enstar Group that, at closing, Cavello Bay assumed reserves totalling approximately \$441 million, and received an equal amount of assets, plus a ceding commission of \$14 million.
- On 27 December 2018, Brittany Insurance Company Ltd ("Brittany"), a Bermuda domiciled exempted insurance company that had been acquired by the Enstar Group in 2001, merged with and into Cavello Bay. I am informed by Enstar Group that, as at 31 December 2018, the net loss reserves of Brittany totalled approximately \$11 million (including environmental and health hazard exposures emanating from business written between 1976 and 1993), and the net assets totalled \$25 million.
- On 11 December 2018, the Enstar Group announced that it has entered into a joint venture to invest in Enhanced Reinsurance Limited ("Enhanced"), a Bermuda-based company that will reinsure life, non-life run-off and property and casualty insurance business initially sourced from Allianz SE and the Enstar Group. I have been informed that the Enstar Group will own 47.4% of Enhanced and that the Enstar Group and its joint venture partners have committed \$470 million of equity investment to Enhanced. The Enstar Group's investment in Enhanced is via Cavello Bay. I have been informed that, as at 31 December 2018, Cavello Bay had paid capital calls totalling \$94.8 million.

4.131 No other significant transactions are presently anticipated although it is possible that others might be undertaken at some future time. However, those will be considered in the context of Cavello Bay's existing capital and other resources and its risk appetite. I have not considered further in this Report the possibility of Cavello Bay accepting in future any as yet unknown but significant reinsurance liabilities.

4.132 Cavello Bay is registered and regulated in Bermuda. Its position relative to UK and non-UK EEA regulated entities will not be affected by Brexit. The Enstar Group has no specific plans for Cavello Bay in respect of Brexit.

THE TRANSFERRING BUSINESS

4.133 The Transferring Business comprises:

- The RSAI Transferring Business: this is made up of UK Asbestos, Noise-Induced Hearing Loss (“NIHL”), Abuse and Other Disease liabilities (e.g. Vibration White Finger and other long-tail disease types as defined by the ABI) and some Non-disease liabilities. The underlying contracts were primarily a mixture of Employers Liability (“EL”) and Public Liability (“PL”) covers. The Non-disease liabilities were written on Professional Indemnity and Financial Risks, Construction, Power and Engineering policies. There are also some London Market Non-Marine liabilities on a small number of inwards reinsurance contracts that had been specifically excluded by the RSA Group from its sale in 2009 of British Engine Insurance Limited to the Enstar Group. All of the RSAI Transferring Business was written prior to the 2006 underwriting year. I am informed that the RSAI Transferring Business is composed of 2,964,000 policies in respect of 1,588,728 policyholders. Approximately 85% of the reserves relating to the RSAI Transferring Business are in respect of EL policies, with the balance being attributable mainly to PL and a small amount of Professional Indemnity business.
- The MIC Transferring Business: this is made up of mostly US Asbestos, Pollution and Health Hazard (“APH”) liabilities. The underlying contracts were:
 - All Marine Energy business within MIC written prior to the 2004 underwriting year;
 - All other Marine business within MIC written prior to the 1997 underwriting year;
 - All Aviation business within MIC.
- The MIC Transferring Business is composed of 650,000 policies in respect of 35,224 policyholders. Marine business represents approximately 63% of the reserves of the MIC Transferring Business (the majority of which relates to US product and public liability policies), with the remainder being Aviation business. Both the Marine and Aviation portfolios include inwards reinsurance business, which makes up about 15% of the total reserves in respect of the MIC Transferring Business.

4.134 As well as business written originally by RSAI or by MIC, the Transferring Business includes business written originally by entities other than RSAI or MIC and subsequently transferred into either RSAI or MIC.

4.135 The Transferring Business comprises mostly what is commonly referred to as the legacy business of RSAI and MIC. However, certain policies and portfolios within the legacy business are specifically excluded from the RSAI Transferring Business. These include (but are not limited to) the following:

- Business written as part of the International Oil Insurers pool and the British Insurance (Atomic Energy) Committee for American Risks pool;
- Business underwritten by or on behalf of RSAI or RSA Re (as reinsurer) and Arrowood Indemnity Company or any company controlled by Arrowpoint Capital (as cedant);
- Business transferred to RSAI from Harworth Insurance Company Limited;
- Business written by RSAI in support of business produced by its Strategic Network Partners or RSAI's overseas branches; and
- Business written by RSAI's overseas branches.

4.136 As at 31 December 2017, RSAI's best estimate value, on an undiscounted basis, of the outstanding liabilities of the Transferring Business was roughly £908 million (£825.7 million in RSAI excluding the business reinsured from MIC, £82.3 million in MIC) plus £17 million (£13 million in respect of RSAI business, with the balance in respect of MIC business) in respect of claims handling costs, gross of outwards reinsurance.

- 4.137 There are various outwards reinsurance assets that support the Transferring Business. RSAI's best estimate value, on an undiscounted basis, of the expected recoveries in respect of the outwards reinsurance, is £113 million, which is the equivalent of approximately 12½% of the value, on an undiscounted basis, of the outstanding liabilities of the Transferring Business. The counterparties are of good standing, with 89% of reinsurance being provided by members of the group headed by Berkshire Hathaway Inc. or by other entities rated A- or better.
- 4.138 The booked values in the Report & Accounts for RSAI and MIC are discounted for the time value of money, and for RSAI the booked value also includes a risk margin. For MIC, the booked provisions for the MIC Transferring Business are £73.0 million, gross of reinsurance, with the external reinsurers' share of the booked provisions being £21.8 million (with RSAI's share, as it fully reinsures the MIC transferring business, being the balance of £51.2 million); for RSAI the booked provisions for the RSAI Transferring Business (which includes the reinsurance of the MIC Transferring Business) are £614.1 million, gross of reinsurance, with the reinsurers' share of the booked provisions being £59.6 million.
- 4.139 There is one ILU Guarantee in place over a portion of the Transferring Business that currently sits within MIC.
- 4.140 The Transferring Business has resided in either RSAI or MIC since the completion of a significant reorganisation and rationalisation of the business in 2011 (effective 1 January 2012) in preparation for Solvency II. This involved the transfer of business, including legacy business forming part of the Transferring Business, to RSAI and MIC pursuant to four insurance Part VII transfer schemes. Reinsurance agreements were also put in place under which 100% of the liabilities in MIC were and remain reinsured into RSAI. Due to these arrangements, the net economic liability for the Transferring Business lies entirely with RSAI.
- 4.141 The Transferring Business includes some liabilities resulting from RSAI's participation in various insurance risk pools (in particular, Electricity Supply Industry Run-Off Services Limited ("EIROS"), which has been fully in run-off since 1982 – RSAI has a 32.66% share of the liabilities of EIROS). The claims handling for those pools is conducted by third parties. Otherwise, RSAI currently has responsibility for all claims handling in relation to the Transferring Business.
- 4.142 The Transferring Business also includes RSAI liabilities in respect of Timber & General. Timber & General went into run-off in 1972 after getting into financial difficulties, and was subsequently novated into another insurer, which is now part of the RSA Group. Its ongoing liabilities are funded by a panel of insurers, with RSAI responsible for 33%.
- 4.143 As described in paragraph 1.11 above, as a precursor to the Scheme, the RSAI Transferring Business (plus RSAI's 100% reinsurance of the MIC Transferring Business) was 100% reinsured, via the Reinsurance Agreement, initially by Fitzwilliam and subsequently, following novation of the Reinsurance Agreement, by Cavello Bay, which now 100% reinsures the RSAI Transferring Business, plus RSAI's 100% reinsurance of the MIC Transferring Business. Thus, the economic liability for the Transferring Business currently lies within the Enstar Group (subject to the limit in the cover provided under the Reinsurance Agreement).

Risks

- 4.144 RSAI has identified many uncertainties regarding the ultimate outcome for the Transferring Business. While some of these uncertainties could result in ultimate losses that are less than those currently forecast, others could result in material deterioration in the ultimate claim costs. These are discussed in more detail in Section 6, in particular:
- There is considerable uncertainty regarding the eventual costs relating to EL Mesothelioma claims, as discussed in paragraph 6.63 below.
 - There is considerable uncertainty regarding the eventual costs relating to NIHL claims, as discussed in paragraph 6.63 below.
 - There is considerable uncertainty regarding the eventual costs relating to Abuse claims, as discussed in paragraph 6.63 below.

THE REINSURANCE AGREEMENT

- 4.145 Under the terms of the Reinsurance Agreement, Cavello Bay agreed to 100% reinsure the RSAI Transferring Business plus RSAI's 100% reinsurance of the MIC Transferring Business (including any ULAE directly attributable to the Transferring Business) with effect from 31 December 2016. In exchange, RSAI agreed to pay premium amounts equal to 95.8% of the undiscounted (best estimate) reserves of the liabilities within the Transferring Business not denominated in USD and to 95.8% of the undiscounted (best estimate) reserves of the USD-denominated liabilities within the Transferring Business. The initial premium paid by RSAI was £799 million (equivalent to undiscounted net technical reserves of £834 million), which was subsequently adjusted to £801.7 million (equivalent to undiscounted net technical reserves of £836.8 million).
- 4.146 The maximum aggregate amount payable by Cavello Bay under the Reinsurance Agreement is £1.46 billion.
- 4.147 The reinsurance has no termination date. It can only be terminated by Cavello Bay if (1) RSAI has acted fraudulently in relation to the transaction documents or has knowingly withheld information, (2) RSAI has breached certain fundamental warranties, or (3) it becomes unlawful in any applicable jurisdiction for either Cavello Bay or RSAI to give effect to its obligations under the transaction documents.
- 4.148 RSAI agreed (on its own behalf and that of MIC) that there would be no change to the way that claims would be handled compared with how they had been handled over the 12 months preceding entry into the Reinsurance Agreement.
- 4.149 The management of all practical and day-to-day operational matters relating to the Reinsurance Agreement is being over seen by a committee ("Reinsurance Oversight Committee") comprising three representatives of each of RSAI and of Cavello Bay.

Collateral and security

- 4.150 The conditions of the Reinsurance Agreement require Cavello Bay to maintain on deposit with a custodian an amount equal to a percentage of the undiscounted net technical reserves of the reinsured business. As at the date of the Reinsurance Agreement (7 February 2017), the percentage was to be 100%. Thereafter, on the first day of each quarter, starting 1 April 2017, the percentage is to be increased by 250 basis points up to a maximum of 120%. The selected custodian is the Bank of New York Mellon.
- 4.151 Furthermore, on 7 February 2017, EGL entered into a Deed of Guarantee with RSAI and MIC whereby it agreed that, should Cavello Bay fail to meet any of its obligations and liabilities to RSAI and MIC under the terms of the Reinsurance Agreement, EGL would meet those obligations itself as if it were the principal obligor.
- 4.152 I discuss the changes to the Reinsurance Agreement that will follow approval of the Scheme in Section 5 below.

5. THE PROPOSED SCHEME

SUMMARY OF THE SCHEME

- 5.1 The following is intended to summarise the terms of the Scheme, as set out in the Transfer Document. For the avoidance of doubt, the terms of the Scheme as set out in the Transfer Document are definitive.
- 5.2 Assuming that the Court approves the Scheme as proposed, the Transferring Business and the Transferring Assets will be transferred to Mercantile (the Transferee) from RSAI and MIC (the Transferors) at and with effect from 00.01 hours GMT on the Effective Date (1 July 2019). Specifically, by order of the Court, the following shall be transferred to and vested in Mercantile on or with effect from the Effective Date:
- the rights, benefits and powers of the Transferors in relation to the Transferring Business or arising as a result of either of the Transferors having carried on the Transferring Business;
 - all assets relating directly to the Transferring Business and all the interest and title of the Transferors in them; and
 - all liabilities of the Transferors under or in respect of the Transferring Policies or attributable to the Transferring Business (which will then cease to be liabilities of the Transferors).
- 5.3 As the Transferring Business is currently 100% reinsured by Cavello Bay, either directly or via RSAI's reinsurance of the MIC Transferring Business, the Transferring Assets essentially comprise outwards reinsurance contracts (or, in respect of any reinsurance contract that covers both policies within the Transferring Business and policies that will remain with the Transferor(s) post the Effective Date, such rights and obligations under that contract that relate to the Transferring Business), as well as the business records and contracts relating to the Transferring Business. On or with effect from the Effective Date, all rights, benefits and powers conferred or vested in, and all liabilities imposed on, the Transferors in respect of the Transferring Business in respect of these outwards reinsurance contracts will be transferred to Mercantile. The Scheme provides that the reinsurers in respect of the Transferring Business will have no greater or lesser liability to Mercantile under any reinsurance contracts relating to the Transferring Business than they would have had to the Transferors (under the same reinsurance contracts) in the absence of the Scheme.
- 5.4 For the avoidance of doubt, I wish to make it clear that no policies of RSAI or of MIC other than those within the Transferring Business will be transferred under the Scheme. Similarly, no assets or liabilities of RSAI or of MIC other than those referred to in paragraph 5.2 above will be transferred under the Scheme.
- 5.5 I also wish to make clear that any and all internal reinsurance contracts between the Transferors (including the arrangement whereby RSAI 100% reinsures all of MIC's business, of which the MIC Transferring Business is part), or between a Transferor and another member of the RSA Group, are excluded from the Scheme and will not be transferred under the Scheme. Similarly, certain stop loss and quota share contracts, underwritten by Munich Re and applying to RSAI's whole account for underwriting years 1999-2004, are also excluded and will not be transferred under the Scheme.
- 5.6 There will be no changes to the terms and conditions of any policy included within the Transferring Business as a result of the Scheme. RSAI's and MIC's respective rights and obligations under the policies that comprise the Transferring Business will be transferred, without alteration, to Mercantile. Similarly, it is intended that there will be no change in how the Transferring Business is administered as a result of the Scheme. All holders of policies included within the Transferring Business will be entitled to the same rights against Mercantile as were available to them against the relevant Transferor under such policies and will be accountable to Mercantile for any further or additional premiums or other amounts attributable or referable thereto as and when the same become due and payable.
- 5.7 There is one ILU Guarantee in place over a portion of the MIC Transferring Business, with RSAI as the guarantor. Subject to the consent of the ILU, this guarantee will be surrendered with effect from the Effective Date, and simultaneously a replacement guarantee will be put in place that will cover the same business as currently covered by the ILU Guarantee, with a suitable Enstar entity being the guarantor of the replacement guarantee.

- 5.8 Liabilities under certain policies within the Transferring Business are supported by letters of credit (“LOCs”) issued on behalf of RSAI and MIC (as appropriate). This arises out of a requirement to post a LOC under the particular policy in order that the policyholder (US-domiciled) can claim the full value of the related asset in its balance sheet. It is intended that these LOCs will be included within the assets to be transferred under the Scheme to Mercantile on the Effective Date.
- 5.9 Any pending or current proceedings or complaints issued or served before the Effective Date by or against either Transferor in connection with the Transferring Business shall be continued by or against Mercantile in place of the relevant Transferor, and the Transferors shall cease to have any liability under those proceedings following the Effective Date. Any proceedings or complaints issued or served on or after the Effective Date that would hitherto have been by or against either Transferor will instead be by or against Mercantile. Mercantile shall be entitled to all defences, claims, counterclaims and rights of set-off that would have been available to the Transferors in respect of the Transferring Business.
- 5.10 Any judgment, order or award in respect of the Transferring Business that is not fully satisfied before the Effective Date will become enforceable by or against Mercantile in the place of the relevant Transferor.
- 5.11 Mercantile shall indemnify each Transferor against any loss or expense incurred by that Transferor, whether before or after the Effective Date, that is attributable to the Transferring Business.
- 5.12 All costs and expenses incurred in connection with the preparation and carrying into effect of the Scheme, whether before or after the Effective Date, shall be paid by the Transferors and the Transferee (and not by the policyholders of the Transferring Business).
- 5.13 The terms of the Scheme are governed by English law.

US Surplus Lines

- 5.14 The MIC Transferring Business includes certain of the business written by MIC as a US surplus lines insurer. As discussed in paragraph 4.93 above, Mercantile has obtained the relevant approvals from the IID in order to set up a US SLTF as security for those MIC Transferring Policyholders with US surplus lines policies.

MOTIVATION FOR THE SCHEME

- 5.15 The Transferring Business largely comprises most of the managed portfolio within RSAI and MIC of legacy insurance business, i.e. lines of business that are no longer considered core to RSAI or to MIC, or which have been in run-off for a protracted period. To enable RSAI and MIC to focus on their core businesses, they wish to transfer the legal and economic responsibility for the Transferring Business to a suitable third party.
- 5.16 In February 2017 RSAI entered into the Reinsurance Agreement under which Fitzwilliam 100% assumed the RSAI Transferring Business plus RSAI’s 100% reinsurance of the MIC Transferring Business. Subsequently, as had been intended (subject to necessary regulatory approval) at the time that the Reinsurance Agreement was signed, the Reinsurance Agreement was novated from Fitzwilliam to Cavello Bay. MIC’s net liability in respect of the Transferring Business was nil before the Reinsurance Agreement and remains nil. As a result of the Reinsurance Agreement, RSAI’s net liability in respect of the Transferring Business is also now nil; Cavello Bay ultimately carries the economic liability for the Transferring Business.
- 5.17 The purpose of the proposed Scheme is to provide legal finality for RSAI and MIC in respect of the Transferring Business, to match the economic (near) finality provided by the Reinsurance Agreement.

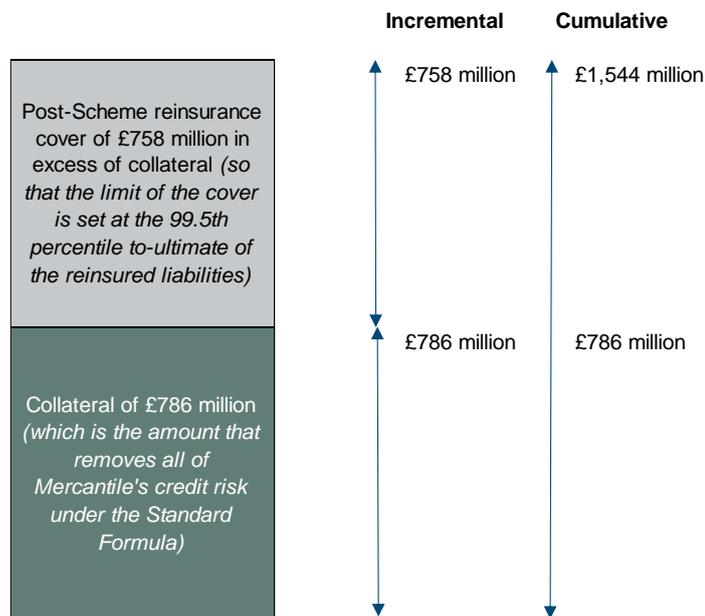
THE REINSURANCE AGREEMENT

- 5.18 Assuming that the Scheme goes ahead, the Reinsurance Agreement, pursuant to which Cavello Bay provides reinsurance cover in respect of the Transferring Business, will novate on the Effective Date from RSAI to the benefit of Mercantile, subject to various additional changes to the Reinsurance Agreement that have been agreed between Cavello Bay, Mercantile and EGL, and which will take effect on and from the Effective Date. These additional changes include the following:

- The percentage of the liabilities ceded to Cavello Bay by Mercantile will be reduced from 100% to 75%;
- The policy limit in the Reinsurance Agreement will be set to be equal to 75% of the estimate, as at the Effective Date, of the 99.5th percentile of the range of possible ultimate outcomes in respect of the outstanding claim costs of the Transferring Business. In practice, this will be based on the year-end 2018 position, rolled forward to the Effective Date (subject to a minimum of £1,500 million). Based on the year-end 2017 position, the 99.5th percentile is £1,544 million.
- The required collateral shall be set at the amount that is sufficient to ensure that Mercantile’s credit risk, in respect of the Reinsurance Agreement and under the Solvency II Standard Formula, is zero. The required amount will be re-evaluated as at each quarter-end and the collateral reset, subject to the limit. Based on the 2017 year-end position, I understand the required collateral to be £786 million, or 126% of net undiscounted reserves (including expenses) in respect of the Transferring Business ceded to Cavello Bay, based on the year-end 2017 position. The collateral will be maintained at the calculated amount immediately from the Effective Date, with no gradual build-up. I discuss in Section 6 below how I have assessed the validity of this collateral amount.
- EGL’s guarantee in respect of the performance of Cavello Bay will remain in place but will be novated to be for the benefit of Mercantile rather than for RSAI and MIC.
- EGL will make available to Mercantile: (1) sufficient capital to enable Mercantile to meet its capital requirements; and (2) assets to enable Mercantile to discharge liabilities that arise from the portion of the Transferring Business that is not reinsured by Cavello Bay where Mercantile is unable to meet these liabilities from its own assets, subject to a limit equal, as at the Effective Date, to the 99.5th percentile of the range of possible outcomes in respect of that portion of the Transferring Business that is not reinsured by Cavello Bay.
- The role of the Reinsurance Oversight Committee will be redundant and the committee will therefore be disbanded.

5.19 The following is a schematic representation of the cover provided by Cavello Bay under the Reinsurance Agreement on conclusion of the Scheme (with amounts based on year-end 2017 position):

Figure 5.1
Cover provided by Cavello Bay to Mercantile under the amended terms of the Reinsurance Agreement, the amendments to be operational from the Effective Date (based on the year-end 2017 position)



POLICYHOLDERS AFFECTED

- 5.20 I have considered the effects of the Scheme on the following groups of policyholders:
- the RSAI Transferring Policyholders (including individuals with outstanding claims in respect of those policies);
 - the MIC Transferring Policyholders (including individuals with outstanding claims in respect of those policies);
 - the current policyholders of RSAI who have policies that are not being transferred under the Scheme; and
 - the current policyholders of MIC who have policies that are not being transferred under the Scheme.
- 5.21 Mercantile currently has no policyholders, and will continue to not have any policyholders until the Scheme is effected, so I do not need to consider the likely effects of the Scheme on existing Mercantile policyholders.
- 5.22 I do not consider that the policyholders of any other insurance companies are affected by the Scheme.

NON-TRANSFERRED POLICIES

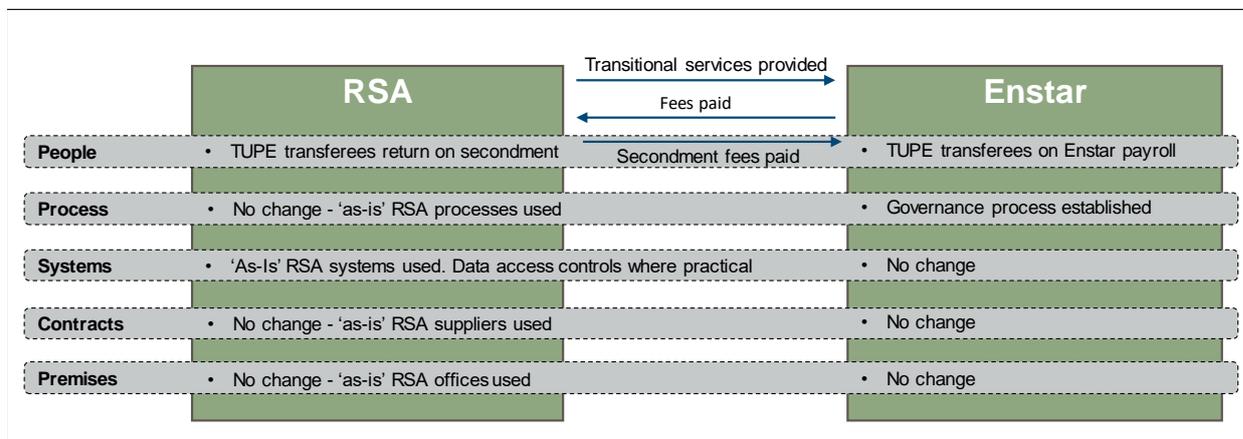
- 5.23 Any policy within the Transferring Business that is not capable of being transferred for legal reasons will be treated as a “Non-Transferred Policy”. I refer to any Non-Transferred Policy that arises from the RSAI Transferring Business as a “RSAI Non-Transferred Policy” and any Non-Transferred Policy that arises from the MIC Transferring Business as a “MIC Non-Transferred Policy”. Post the Effective Date, any and all Non-Transferred Policies will be fully reinsured by Mercantile, for no further consideration. The Non-Transferred Policies will be treated by Mercantile no less favourably than they would be had they been transferred as part of the Scheme.
- 5.24 Post the Effective Date, any outwards reinsurance contracts that applied to Non-Transferred Policies (other than reinsurance contracts that cover both Non-Transferred Policies and policies that are intended to remain with the Transferor(s) post the Effective Date) will have been transferred to Mercantile and therefore the Non-Transferred Policies will no longer be reinsured under those contracts. Instead, Mercantile will assume the gross liabilities of the Non-Transferred Policies and shall then cede to each reinsurer that is party to such outwards reinsurance contracts such liabilities (if any) as would have been ceded to those reinsurers had the Non-Transferred Policies transferred.
- 5.25 If there are any Non-Transferred Policies post the Effective Date then the Companies shall work towards subsequently transferring each and every Non-Transferred Policy to Mercantile, by novation or other means.
- 5.26 While it is possible that there will be some Non-Transferred Policies, I am informed by both RSAI and Enstar Group that, based both on the due diligence undertaken prior to entering into the BTA and on work undertaken subsequently, none are currently expected.

ADMINISTRATION

- 5.27 Mercantile shall use its reasonable endeavours to ensure that, for the 12 months following the Effective Date, the Transferring Business is administered with a level of service consistent with that which applied to the Transferring Business in the 12 months immediately preceding the date of signing the BTA (including, without limitation, in respect of fair treatment of customers and any obligation or service undertaken by the RSA Group in respect of the requirements, activities or operation of the Employers’ Liability Tracing Office (“ELTO”)).
- 5.28 Subsequently, Mercantile shall use its reasonable endeavours to ensure that the Transferring Business is administered with a level of service in accordance with standards that:
- accord with generally accepted good industry practice;
 - accord with all applicable laws and regulation; and
 - are at least consistent with the standards of administration provided by the Enstar Group in its business generally.

- 5.29 Joint RSAI and Enstar working groups have formulated the Separation and Migration Plan for the transfer from RSAI and MIC systems to Mercantile systems of the claims and policy information relating to the Transferring Business, under the overall control and direction of a joint Separation and Migration Steering Committee. The Separation and Migration Steering Committee is now managing the separation and migration process, in accordance with a fully detailed project plan, originally agreed in the final quarter of 2017 and subsequently amended to allow for emerging experience, most recently in the final quarter of 2018.
- 5.30 RSAI is responsible for activities required to “disconnect” operations and extract data. The Enstar Group is responsible for all subsequent “reconnect” and integration activities, including data transformation, loading and integration, as well as establishing and/or integrating business processes and staff training.
- 5.31 It is intended that, post-completion of the Scheme and of the Separation and Migration Plan, the principal service provider to Mercantile will be EEUL under an outsourcing agreement. To that end, there will be a TUPE transfer of the Assumed Employees to EEUL on completion of the Scheme (see paragraph 5.43 below – the consultation process is already underway). The transfer of the Assumed Employees will therefore ensure substantial continuity in the administration of the business post-Scheme, and in the knowledge and specific expertise required to perform that administration. Post-Scheme, the Assumed Employees will complement the existing expertise of EEUL and the wider Enstar Group in the run-off of long-tail liabilities. Business contracts relating exclusively to the Transferring Business and dealings with third party solicitors, attorneys and loss adjusters in relation to the Transferring Business will be transferred to Mercantile on completion of the Scheme and Mercantile will then delegate the handling of those contracts and dealings to the appropriate parts of the Enstar Group. Further details are provided in paragraph 6.140 below.
- 5.32 While paragraph 5.31 above sets out what is intended to happen post-completion of both the Scheme and the Separation and Migration Plan, I have been informed that the Separation and Migration Plan is on track to be fully completed and implemented by the end of the third quarter 2019, but not ahead of the Effective Date. Therefore, as an interim measure between the Effective Date and the full completion and implementation of the Separation and Migration Plan (i.e. the Migration Date), Mercantile will require certain services from RSAI to enable it to service the Transferring Business. Accordingly, RSAI and Mercantile have agreed to enter into an outsourcing agreement (the “Outsourcing Agreement”) ahead of the Effective Date. They have further agreed that the terms of the Outsourcing Agreement shall incorporate the following:
- The term of the Outsourcing Agreement shall last from the Effective Date to the Migration Date (i.e. until migration and separation are completed in accordance with the BTA);
 - The services to be provided by RSAI will include, in respect of the Transferring Business, all claims handling, all investigations of coverage, the provision of business information, aggregate management and reinsurance administration;
 - The Assumed Employees, who will be TUPE transferred from RSAI to EEUL on the Effective Date, will immediately be seconded by EEUL back to RSAI in order to provide the outsourced services, and will continue to have access to the systems and infrastructure of RSAI as necessary to provide the outsourced services;
 - Those RSAI employees who are not among the Assumed Employees but who currently provide services relating to the Transferring Business shall continue to support the Transferring Business;
 - While EEUL shall be responsible, post-Effective Date, for managing and overseeing the Assumed Employees from a Human Resources perspective, RSAI shall be responsible for the day-to-day operational management and oversight of the Assumed Employees while they are performing the services required by the Outsourcing Agreement, to ensure that they comply with the agreed service levels.
- 5.33 Figure 5.2 below provides a schematic overview of the Outsourcing Agreement

Figure 5.2
Overview of the Outsourcing Agreement



- 5.34 I note that RSA and Mercantile have agreed the Term Sheet for the Outsourcing Agreement but, at the time of drafting this Report, the Outsourcing Agreement itself has not yet been signed. I shall report on the signing of the Outsourcing Agreement in my Supplementary Report.
- 5.35 The UK non-life run-off companies within the Enstar Group, including Mercantile, have established an Executive Committee (“Exco”), which has authority to act on their behalf, subject to its terms of reference. Mercantile will appoint an executive Board director and/or appropriately qualified senior manager to own the prescribed responsibility of monitoring all outsource arrangements. The Exco will support this prescribed responsibility.
- 5.36 In this way, a common standard of operation will be maintained for all UK non-life run-off companies within the Enstar Group, regardless of their size. All companies are subject to the same core focus on operational matters.

Data

- 5.37 It is intended that all data relating to the Transferring Business will be migrated from RSA’s core and non-core systems onto either the Enstar Group’s new Commercial Liability platform (“Pelican+”, a system originally developed by Pro Global Solutions Limited (“Pro”) specifically as a claims administration/management system in respect of long-tailed disease claims, which is already being used by some other insurers) or its existing London Market platform, Iris. End-user databases, working spreadsheets and other tools relating to the management and administration of the Transferring Business will be cleansed and transferred to the Enstar Group.
- 5.38 Pro will maintain the Pelican+ system in accordance with various service level agreements between it and EEUL. EEUL staff will access the Pelican+ system via a web browser.

Risks within the Separation and Migration Plan

- 5.39 The plan has a key dependency on Information Technology (“IT”), in particular in the successful and timely development by the Enstar Group of Pelican+. The Enstar Group also needs to build a series of new reports within its primary Management Information tool and within other secondary reporting tools to provide management information for the Transferring Business. As anticipated within the Separation and Migration Plan, configuration of the reporting tools has now been specified and these tools are currently being developed. Further migration and reconciliation work is scheduled to continue into early 2019, whereupon the focus moves to testing (the testing has already commenced).
- 5.40 The retention of key personnel, especially among the Assumed Employees, is also a key dependency.

- 5.41 The plan includes arrangements to mitigate the identified key risks. I note that it is intended that the Outsourcing Agreement will run until the Migration Date. While it is expected that the Migration Date will not be later than 1 October 2019, there is no absolute time limit to the Outsourcing Agreement, which will continue to operate until such time as the Separation and Migration Plan has been successfully completed and implemented. In any event, it is intended that there be a period of parallel running of both Pelican+/Iris and the existing IT platform, to ensure that the data transfer has been successful and that the Transferring Business is being appropriately managed in its new IT environment.
- 5.42 I shall comment in my Supplementary Report on progress against the Separation and Migration Plan.

Staff

- 5.43 The Assumed Employees number about 60 people. They are expected to transfer from RSAI to EEUL under TUPE regulations. It is anticipated that the Assumed Employees will enable the Enstar Group to retain substantial process knowledge, customer relationships and claim history regarding the Transferring Business to help maintain services and enact a smooth transition. RSAI and the Enstar Group will monitor the resources closely to ensure that sufficient staff of appropriate skills and experience are in place to be able to maintain customer service levels. As explained in paragraph 5.32 above, the Assumed Employees will be seconded by EEUL back to RSAI for the term of the Outsourcing Agreement. RSAI and the Enstar Group have included within the Separation and Migration Plan time for joint knowledge-transfer sessions in respect of individuals who are currently supporting the Transferring Business but who are not expected to transfer. Those individuals will continue to support the Transferring Business for the term of the Outsourcing Agreement.

COMPENSATION AND COMPLAINTS

- 5.44 The Scheme will have no impact on the eligibility of any policyholder or group of policyholders for compensation under the FSCS as they will continue to be policyholders of a UK domiciled and regulated insurance company. Further details regarding what the FSCS covers are given in paragraph 3.9 above.
- 5.45 The Scheme will have no effect on the eligibility of any policyholder or group of policyholders to bring complaints to the UK FOS as they will continue to be policyholders of a UK domiciled and regulated insurance company. If, as described in Section 3, they are currently able to bring complaints to the FOS, then this will remain the case after the implementation of the Scheme. If they are currently not eligible to complain to the FOS then this will also remain the case after the implementation of the Scheme.

EFFECT OF THE SCHEME ON THE BALANCE SHEETS OF RSAI, MIC AND MERCANTILE

- 5.46 Table 5.1 below shows simplified balance sheets for RSAI as at 31 December 2017²⁸ in two situations:
- The “Actual” column shows the actual balance sheet as at 31 December 2017.
 - The “Post-Scheme” column shows what the balance sheet would have looked like as at 31 December 2017 had the Scheme been approved and become effective as at 31 December 2017. This would have reduced both the gross technical provisions and reinsurers’ share of technical provisions by £644 million, the value as at 31 December 2017 of the Assets and Liabilities held for sale and disposal groups. I have assumed that no further margins would be transferred as part of the Scheme. It should be noted that the figures in Table 5.1 have not been adjusted for the transfer of RSAI’s non-UK EU business to RSAL, effective 1 January 2018.

28 Based on RSAI’s Annual Report as at 31 December 2017.

Table 5.1
Simplified Balance Sheets for RSAI as at 31 December 2017 (in £ millions)

	Actual	Post-Scheme
Assets		
Investments	17,817	17,817
Reinsurers' share of technical provisions	1,782	1,782
Debtors and salvage	3,256	3,256
Other assets	309	309
Prepayments and accrued income	517	517
Intangible assets	151	151
Assets held for sale and disposal groups	644	0
Total Assets	24,476	23,832
Liabilities		
Capital and reserves	7,974	7,974
Gross technical provisions	6,827	6,827
Other provisions	233	233
Creditors	8,537	8,537
Accruals and deferred income	261	261
Liabilities for disposal groups	644	0
Total Liabilities	24,476	23,832

5.47 Table 5.2 below shows simplified balance sheets for MIC pre- and post-Scheme, based on its statutory accounts as at 31 December 2017²⁹.

29 Based on MIC's Annual Report as at 31 December 2017.

Table 5.2
Simplified Balance Sheets for MIC as at 31 December 2017 (in £'000)

	Actual	Post-Scheme
Assets		
Investments	30,116	30,116
Reinsurers' share of technical provisions	39,340	39,340
Debtors and salvage	28,610	28,610
Other assets	1,625	1,625
Prepayments and accrued income	4,976	4,976
Assets held for sale and disposal groups	75,719	0
Total Assets	180,386	104,667
Liabilities		
Capital and reserves	49,704	49,704
Gross technical provisions	39,369	39,369
Creditors	10,732	10,732
Accruals and deferred income	4,862	4,862
Liabilities for disposal groups	75,719	0
Total Liabilities	180,386	104,667

5.48 Table 5.3 below shows simplified balance sheets for Mercantile pre- and post-Scheme, based on its statutory accounts as at 31 December 2017³⁰.

Table 5.3
Simplified Balance Sheets for Mercantile as at 31 December 2017 (in £'000)

	Pre-Scheme	Post-Scheme
Assets		
Investments	4,153	407,109
Cash	0	45,234
Third party reinsurers' share of technical provisions	0	111,503
Cavello Bay's share of technical provisions	0	590,632
Other reinsurance recoverables	0	15,748
Other assets	50	18
Total Assets	4,203	1,170,244
Liabilities		
Capital and reserves	4,077	257,893
Gross technical provisions	0	899,012
Creditors	68	13,213
Accruals and deferred income	58	126
Total Liabilities	4,203	1,170,244

5.49 It should be noted that the provisions in respect of Transferring Liabilities in the pro forma balance sheets shown in Table 5.1 and Table 5.2 above are on a discounted basis, whereas they are shown in the pro forma balance sheet in Table 5.3 above on an undiscounted basis.

5.50 The reserving strength of RSAI, MIC and Mercantile are discussed in more detail in Section 6 below.

³⁰ Based on Mercantile's Annual Report and Financial Statements as at 31 December 2017.

5.51 Table 5.4 below shows simplified balance sheets for Cavello Bay as at 31 December 2017, in three situations:

- The “Actual” column shows the actual balance sheet as at 31 December 2017.
- “Adjusted for known developments” shows what the balance sheet would have looked like were the transactions announced between the start of 2018 and the date of drafting this Report (see paragraph 4.130 above) been in place as at 31 December 2017.
- “Post-Scheme” shows what the balance sheet would have looked like had those transactions and the Scheme taken place as at 31 December 2017.

Table 5.4
Simplified Balance Sheets for Cavello Bay as at 31 December 2017 (in US\$'000)

	Actual	Adjusted for known developments	Post-Scheme
Assets			
Investments	1,732,159	2,534,940	2,236,334
Cash, restricted cash and equivalents	364,018	117,111	117,111
Funds held - directly managed	180,485	180,485	180,485
Reinsurance balances recoverable	603,801	623,975	588,351
Funds held by reinsured companies	159,066	407,619	407,619
Investments in (partially) owned KaylaRe	309,816	404,616	404,616
Amounts due from related parties	102,730	32,842	32,842
Other assets	89,039	111,106	103,137
Total Assets	3,541,114	4,412,694	4,070,495
Liabilities			
Capital and reserves	1,386,327	1,466,153	1,416,003
Gross technical provisions	2,077,420	2,867,848	2,583,277
Amounts due to related parties	7,150	7,150	7,150
Other liabilities	70,217	71,543	64,065
Total Liabilities	3,541,114	4,412,694	4,070,495

5.52 I note the following about Table 5.4 above:

- The provisions within Cavello Bay’s balance sheet are shown at fair value.
- The “known developments” include the reinsurance of the Zurich, Allianz SE and MRNA portfolios, as well as the merger with Brittany, as described in paragraph 4.130 above. The gross technical provisions associated with these portfolios total \$790.4 million. The Allianz SE, MRNA and Brittany transactions each give rise to an increase in capital and reserves, totalling \$79.8 million (the Zurich transaction is neutral in this regard).
- In addition, the “known developments” allow for the movement of \$250 million from cash into investments.
- The Post-Scheme figures additionally include the impact of the Scheme, had it taken place as at 31 December 2017. Following the Scheme, the Reinsurance Agreement will be novated from RSAI to Mercantile and the cession will be reduced from 100% to 75%. Recognising the reduction in the proportion of business ceded, Cavello Bay will pay \$50.2 million (effectively returning some premium) to Mercantile. As a consequence, as can be seen from Table 5.4 above, post transfer, Cavello Bay’s investments will reduce by \$298.6 million, its gross technical provisions will reduce by \$284.6 million, its reinsurance recoverables will reduce by about \$35.6 million, and its capital and reserve will reduce by \$50.2 million.

APPROACH TO COMMUNICATION WITH POLICYHOLDERS

5.53 RSAI and MIC have set out the approach that they intend to take in communicating information about the proposed Scheme to the affected policyholders and other parties.

5.54 The main objectives of the communications are to:

- Give those policyholders and others who might be affected by the Scheme the information that they need to understand the proposed changes;
- Inform those policyholders and others who might be affected by the Scheme about the implications for them of the proposed changes;
- Give those policyholders and others who might be affected by the Scheme access to further relevant information (beyond that in the communications pack);
- Let those policyholders and others who might be affected by the Scheme know what steps they should take if they object to any of the proposed changes;
- Maintain customers' confidence in Mercantile's willingness and ability to continue to meet its obligations in respect of the Transferring Business;
- Maintain customers' confidence in RSAI's willingness and ability to continue to meet its obligations in respect of the business of RSAI that is not within the RSAI Transferring Business;
- Maintain customers' confidence in MIC's willingness and ability to continue to meet its obligations in respect of the business of MIC that is not within the MIC Transferring Business; and
- Meet legal and regulatory requirements.

5.55 RSAI and MIC intend to notify the following groups about the Scheme:

- All RSAI Transferring Policyholders that have open and/or closed claims and for which an address can be traced/verified;
- All MIC policyholders for which records have been found on systems within the RSA Group and for which an address can be traced/verified;
- All lawyers representing individual claimants with open and closed claims in respect of RSAI Transferring Policyholders for whom records have been found on systems within the RSA Group, with a request that they consider the proposed Scheme on behalf of their clients (there is no need for similar notification in respect of MIC Transferring Business as MIC policyholders present nearly all claims to MIC directly);
- All US attorneys who are named in a policy as the prospective recipient of a service of suit claim against MIC or who have represented MIC in its dealings with a US direct assured;
- All reinsurers with reinsurance agreements relating to the Transferring Business that will be transferred by the Scheme and for which an address can be traced/verified;
- All current known/identifiable brokers or agents with delegated authority, involvement in distribution of policies or managing claims for whom records have been found on systems within the RSA Group (RSAI hopes that these brokers and agents will help it to validate its records of Transferring Policyholders for notification);

- The managers of the various insurance pools, business of which is included within the Transferring Business (e.g. the Associated Insurers (British Electricity) Management Committee, which manages the EIROS Pool and which has undertaken to notify EIROS policyholders, and Global Aerospace Underwriting Management Limited (“GAUM”), which manages the British Aviation Insurance Group (“BAIG”) and London Aviation Insurance Group (“LAIG”) Pools and which will be asked to send the Part VII notification to policyholders of the BAIG and LAIG Pools with details of the Scheme). With regard to EIROS, I am informed that only 14 policies were ever issued and that RSAI has been provided with all contact details for these policyholders. RSAI will directly notify these policyholders of the Scheme, in addition to formally notifying EIROS. With regard to BAIG and LAIG, GAUM has agreed to notify its policyholders of the Scheme and will additionally provide RSAI with details of all policyholders with open claims so that RSAI can notify them directly. I am informed that RSAI has agreed to speak with GAUM immediately upon the commencement of direct notification in order to obtain feedback on GAUM’s intended cascade process, and that RSAI has reminded GAUM (which is fully conversant with the Part VII process) of the requirement to log and forward to RSAI any and all responses that they might receive. MIC is also represented on the GAUM Members Board, enabling it to have oversight of GAUM’s notification actions;
- Other relevant bodies such as industry trade associations and claims representation organisations in relevant jurisdictions with a request that they publicise the Scheme to their members, all active members of the Association of Personal Injury Lawyers (“APIL”), ELTO (requesting that it publicises the Scheme on its website), the NAIC and the British Insurers Brokers’ Association.

5.56 RSAI and MIC will be applying to the Court for waivers in respect of the requirement to make similar direct notification to the following groups:

- Those policyholders of RSAI whose policies are not included within the Transferring Business;
- Claimants (both actual and potential – claims in respect of the Transferring Business are usually brought to the Transferors via the policyholder (MIC) or via the claimant’s lawyers (RSAI) and, as a result, the Transferors usually do not have claimants’ contact details so instead will request the policyholders and lawyers to effect the claimant notification on behalf of those claimants with whom they are dealing);
- Those RSAI Transferring Policyholders and MIC Transferring Policyholders that have open and/or closed claims but for which an address cannot be traced/verified;
- Those RSAI Transferring Policyholders that do not have open or closed claims;
- Those MIC policyholders for which records have been found on systems within the RSA Group but for which an address cannot be traced/verified;
- Those MIC policyholders for which records have not been found;
- Those RSAI Transferring Policyholders and MIC Transferring Policyholders whose names do not appear within computer records of the Transferors as the legal holder of the policy (e.g. subsidiary and affiliate companies of the legal holder of the policy – notification will include the request that policyholders forward the notification to any related party);
- Those MIC Transferring Policyholders whose policies were sold via EIROS, BAIG or LAIG (on the basis that the pool managers hold the policyholder records and therefore they will be asked to effect the notification of those policyholders);
- Those RSAI Transferring Policyholders and MIC Transferring Policyholders with closed claims on short-tail policies where coverage is cargo, hull, specie or transport (for which the likelihood of further claims being notified 12+ years after the covers were written is considered remote);
- All reinsurers with reinsurance agreements relating to the Transferring Business for which an address cannot be traced/verified or who no longer have active balances.

- 5.57 RSAI and MIC will seek to trace and verify all outstanding addresses prior to the dispatch of notifications. They will then seek alternate contact details for those to whom letters have been sent but then returned. They will monitor the contact process, recording the dates on which letters are sent (and returned and resent, also noting all address changes), any queries or objections raised by policyholders or other interested parties and, in each such case, their response.
- 5.58 In addition to direct, written correspondence, indirect notification is also planned. There will be extensive advertising and (as noted above) notification of trade bodies and associations to reach either unknown Transferring Policyholders or those that cannot be traced. The advertising strategy will include at least two national newspapers that relate to the demographic profile of the industries insured and to each of the areas where Transferring Policyholders, reinsurers and relevant third parties are likely to be located, together with international financial publications, namely *The Financial Times* (international edition) *Insurance Day* (worldwide edition) and *The Economist* and UK and US trade journals and specialist periodicals. The notifications will also be placed on relevant websites where applicable.
- 5.59 As, following the Part VII transfer of its remaining business to River Thames Insurance Company Limited, effective 7 April 2017, Mercantile has no policyholders, the Enstar Group does not intend to make any direct notifications regarding the Scheme.
- 5.60 The letters, notices and advertisements will refer all queries to a postal address or a telephone number or a website address, all of which will be dedicated to responding promptly to any such queries. It is intended that both this Report and the Supplementary Report will be published on the RSAI website, on pages dedicated to the Scheme, and that copies will be sent to any policyholders who request them. The Report will be made available in this way immediately following the directions hearing relating to the Scheme (or as soon thereafter that the dedicated pages on the RSAI website have been set up) and the Supplementary Report will likewise be made available at least one week before the date of the Court hearing.
- 5.61 I comment on this proposed approach to communications with policyholders in Section 8.

COSTS

- 5.62 All costs and expenses, including, without limitation, fees and disbursements of legal and financial advisers and accountants, incurred in connection with the Scheme and the transactions contemplated by the Scheme shall be paid by the Transferors and the Transferee in accordance with the terms previously agreed between them.

6. THE IMPACT OF THE SCHEME ON THE TRANSFERRING POLICYHOLDERS

INTRODUCTION

- 6.1 Under the Scheme, the RSAI Transferring Business and the MIC Transferring Business will be transferred to Mercantile.
- 6.2 The main issues affecting the transferring policyholders of RSAI and MIC as a result of the Scheme are likely to arise from relative differences in:
- The financial strength of Mercantile post-Scheme compared with that of RSAI and of MIC. Financial strength is derived from:
 - the strength of the reserves held, relative to a best estimate of the outstanding liabilities;
 - excess assets or capital; and
 - specific financial support arrangements.
 - The risk exposures in Mercantile compared with those in RSAI and MIC.
 - The policy servicing levels provided by Mercantile post-Scheme compared with those currently enjoyed by the RSAI Transferring Policyholders and the MIC Transferring Policyholders.
- 6.3 In this Section of the Report, I deal with each of these in turn.
- 6.4 I note that the reserves held on a GAAP basis differ from the Technical Provisions that are used to determine the own funds available to meet the solvency capital requirements under Solvency II. However, the best estimate of the liabilities under GAAP is usually used as the base for the best estimate of the liabilities under Solvency II, which then forms a key part of the Solvency II Technical Provisions.
- 6.5 While key metrics under Solvency II, such as the SCR, MCR and Eligible Own Funds, are intended to be made public as part of each insurer's annual Solvency Financial Condition Report ("SFCR"), there are other relevant metrics (for example, projected values of own funds and of solvency capital requirements as set out in insurers' ORSAs or in their quarterly Quantitative Reporting Templates ("QRTs")) that are private matters between the entities and the relevant regulators. Therefore, I am not at liberty to disclose in this Report the actual values of those metrics, or figures by which those values could be calculated. In this Report, I have considered the extent to which RSAI, MIC and Mercantile each hold capital in excess of various solvency capital measures. Each entity will have different Capital Cover Ratios for different solvency measures. Where permitted I have expressed Capital Cover Ratios in numeric terms. In other instances, for comparative purposes in this Report, I have defined the following terms:
- "sufficiently capitalised" refers to a Capital Cover Ratio between 100% and 119%;
 - "more than sufficiently capitalised" refers to a Capital Cover Ratio between 120% and 149%;
 - "well-capitalised" refers to a Capital Cover Ratio between 150% and 199%, and
 - "very well-capitalised" refers to a Capital Cover Ratio in excess of 200%.

RESERVE STRENGTH OF RSAI (PRE- AND POST-SCHEME)

- 6.6 In its statutory accounts as at 31 December 2017, RSAI held gross technical provisions of £6.8 billion (made up of £2.3 billion of unearned premium reserves and £4.5 billion of outstanding claims). Reinsurers' share of technical provisions totalled £1.8 billion (made up of £0.7 billion in respect of unearned premiums and £1.1 billion in respect of claims outstanding). The gross technical provisions and the reinsurers' share of those provisions are on an undiscounted basis. The accounts separately identified £614 million of additional technical provisions and corresponding reinsurance assets for disposal. These amounts (which were discounted for the time value of money) were in respect of the RSAI Transferring Business and RSAI's reinsurance of the MIC Transferring Business.

- 6.7 Therefore, the RSAI Transferring Business (together with RSAI's 100% reinsurance of the MIC Transferring Business) represents a material portion of RSAI's gross technical provisions (roughly 12% based on the undiscounted figures shown in the 31 December 2017 accounts). However, as the RSAI Transferring Business is now 100% reinsured by Cavello Bay, RSAI's net liability in respect of the RSAI Transferring Business (up to the limit of the reinsurance) is nil on a GAAP basis. As a result, the Scheme will have no effect on the estimated reserves of RSAI, net of reinsurance, on a GAAP basis.
- 6.8 In this sub-section of the Report, I provide details of my review of the reserve strength of RSAI. My focus in this review has been on the reserves held for the RSAI Transferring Business. As noted above, as the RSAI Transferring Business is already 100% reinsured, the Scheme will not affect the estimated net reserves of RSAI. However, as the reserves booked by RSAI in respect of the RSAI Transferring Business have been used by the Enstar Group in its capital calculations and business plans for Mercantile, the appropriateness of these reserves is important in assessing whether the security currently afforded to the Transferring Policyholders will be materially affected by the Scheme.
- 6.9 I have been provided with details of the outstanding claims provisions for RSAI as at 31 December 2017, the process by which the provisions were established and details of the actuarial reviews that have been performed. The outstanding claims provisions so developed and included in RSAI's financial statements (as at 31 December 2017) were prepared in accordance with UK GAAP.
- 6.10 I have not attempted to review in detail the calculations performed by the respective actuaries. Instead, I have reviewed the process by which reserves are set, the approach followed by the relevant actuaries, the key areas of reserve uncertainty and the apparent strength of the reserves based on this review.
- 6.11 The internal actuaries segment the business into three main classes of business, into sub-classes within each class of business, and, in some cases, into reserving populations within (sub) classes, as follows:
- Personal lines:
 - motor (further split by heads of damage, e.g. accidental damage, theft, bodily injury, etc.)
 - household (further split by causations, e.g. fire, accidental damage, etc.)
 - pet
 - other
 - Commercial lines (core):
 - motor
 - property
 - liability
 - professional indemnity
 - marine
 - other
 - Non-core:
 - Inwards reinsurance
 - Pools (largely relating to historical aviation-related exposures and losses)
 - Marine run-off
 - UK asbestos
 - US losses (multi-national clients)

- Disease and abuse.
- 6.12 RSAI's internal actuaries have used generally accepted actuarial methods (including the Chain Ladder³¹, Bornhuetter Ferguson³² and Frequency-Severity³³ methods) to estimate ultimate claim amounts and thus, by deducting payments already made, the reserve requirements (termed "actuarial indications"). For some reserving classes, bespoke methods are used as the characteristics of the reserving population do not support normal techniques – this is particularly true of the non-core business (much of which is made up by the RSAI Transferring Business), which is discussed from paragraph 6.17 below.
- 6.13 The actuarial indications are stated to be on a best estimate basis, i.e. not deliberately biased upwards or downwards, and do not include any margins. I interpret this measure to be on a basis higher than a 50% confidence level (as the claim distribution is expected to be positively skewed³⁴).
- 6.14 The key assumptions underlying the generally accepted actuarial methods are:
- The historic paid and incurred development patterns are indicative of future development, which in turn implies the following further assumptions:
 - Case reserving standards are consistent over time;
 - Claims inflation is broadly stable; and
 - Claims settlement processes are broadly unchanged over time;
 - The estimation (and selection) of the initial expected year loss ratios ("IELR"s), used both for directly estimating ultimate losses for recent exposure periods and as an assumption in the Bornhuetter Ferguson method. For many classes of business, the claims experience is typically immature in the first year, which makes the IELR estimations particularly uncertain. RSAI's internal actuaries have estimated the IELRs as at 31 December 2017 using the RSAI operation plan (and incorporating agreed assumptions for claims inflation and risk mix);
 - Reinsurance recoveries are made as anticipated³⁵ and there is no bad debt other than that directly provided for by RSAI.
- 6.15 Where these assumptions do not apply, or are not supported by the data, the internal actuaries have adjusted the methods to improve the reliability of the estimated results. Further, in relation to claims reserves required for losses arising from Periodic Payment Orders ("PPOs")³⁵, the internal actuaries have estimated the cost of these claims using a discounted cash-flow model, allowing for the mortality of the claimant.
- 6.16 From my review of the various documents supporting the reserve calculations for personal lines and core commercial lines businesses, I am satisfied that:

31 The Chain Ladder method is an actuarial method commonly used to estimate claim reserve amounts. The method considers the historical development of reported paid and incurred claims and then extrapolates this historical claim development into the future in order to estimate future claim development. An important assumption underlying this method is that it expects the future development of claims to be similar to the historical average. The method involves some actuarial judgement in determining the assumption for the pattern of future claims from the historical data.

32 The Bornhuetter Ferguson method is a commonly used actuarial method for estimating claim reserves. It can be thought of as a weighted mixture of the Chain Ladder method and the expected ultimate losses (less paid losses) the latter being typically based on the underwriter's view. For more recent accident (or underwriting) years more weight is given to the expected ultimate losses (where claim based methods are less reliable); for older accident (or underwriting) years more weight is given to the Chain Ladder method (where claim data provides more information).

33 A Frequency-Severity method uses historical data to estimate the expected number of claims and the average cost of each claim. The method multiplies the expected number of claims by the average cost of a claim.

34 A claims distribution of potential losses is said to be positively skewed as the loss cannot be less than zero, but can be many times larger than the mean loss (alternatively, this may be viewed as a distribution of potential losses having a higher frequency of lower value losses, and a lower frequency of higher value losses, e.g. observed losses of: 1, 2, 3, 4, 100).

35 The 2004 Courts Act gives the Court in the UK the right to order periodic payment settlements (also known as Periodic Payment Orders, "PPOs") instead of lump sums in large bodily injury cases irrespective of the wishes of either party. Where awarded, PPOs replace a lump sum that would otherwise have been awarded in respect of future expected costs with an index linked amount payable to a claimant annually for the rest of their lives.

- the reserving methodologies adopted by the RSAI actuaries are consistent with usual market practice; and
- the major assumptions adopted by the RSAI actuaries appear reasonable in the context of the underlying portfolios and of my market knowledge.

Therefore, I conclude that RSAI's reserves as at 31 December 2017 in respect of its personal lines and core commercial lines businesses appear reasonable.

Transferring Business

- 6.17 The vast majority of the reserves for the "non-core" sub-class listed in paragraph 6.11 above is in respect of the Transferring Business. As the MIC Transferring Business is 100% reinsured by RSAI, RSAI holds technical provisions in respect of all of the Transferring Business. In this sub-section, I concentrate on the reserves relating to the RSAI Transferring Business and I discuss the reserves relating to the MIC Transferring Business below in the section relating to the reserve strength of MIC.
- 6.18 Table 6.1 below gives details of the reserves of the main reserving segments of the Transferring Business as at 31 December 2017. The figures are shown both gross and net of reinsurance, and split between outstanding reserves ("OS") and IBNR. It should be noted that, while the RSA Group discounts its legacy reserves for statutory financial reporting purposes, the figures shown below are not discounted for the time value of money.

Table 6.1
Reserves of the Transferring Business by Segment as at 31 December 2017³⁶ (£ millions)

Entity	Segment	Gross			Net		
		OS	IBNR	Total	OS	IBNR	Total
RSAI	Asbestos	64.5	494.2	558.6	58.0	451.5	509.5
RSAI	NIHL	37.0	-3.3	33.7	35.0	-3.3	31.7
RSAI	EIROS	12.3	59.2	71.5	12.3	59.2	71.5
RSAI	Timber & General	6.2	34.7	40.9	2.1	11.5	13.6
RSAI	Abuse	35.1	34.4	69.5	31.5	34.8	66.3
RSAI	Other Diseases	2.8	4.0	6.8	2.1	4.1	6.2
RSAI	Other Non-Disease and Profin	31.7	4.4	36.1	26.5	4.5	31.0
RSAI	Non-US Pollution	0.0	0.8	0.8	0.0	0.8	0.8
<i>Total RSAI</i>		<i>189.6</i>	<i>628.4</i>	<i>817.9</i>	<i>167.5</i>	<i>563.0</i>	<i>730.5</i>
MIC	Aviation Pools	13.8	11.8	25.6	10.2	8.7	18.8
MIC	Aviation Other	3.0	1.8	4.8	0.0	0.0	0.0
MIC	Marine	35.9	14.8	50.7	23.2	14.9	38.1
<i>Total MIC</i>		<i>52.7</i>	<i>28.4</i>	<i>81.0</i>	<i>33.4</i>	<i>23.6</i>	<i>56.9</i>
Grand Total		242.2	656.7	899.0	200.9	586.6	787.4

36 The figures in Table 6.1 are based on RSAI's final view of the actuarial indications as at 31 December 2017. As such, they are consistent with the figures shown in Table 5.4 but inconsistent with the figures in Table 5.1 and Table 5.2, in that the figures for the assets and liabilities held for sale within the 2017 year-end Report & Accounts are (1) based on RSAI's final view of the actuarial indications as at 30 September 2017 and (2) have been discounted for the time value of money and include explicit margins. The undiscounted value of the Transferring Business as at 30 September 2017 was £9.0 million more, gross of reinsurance, and £7.2 million more, net of reinsurance, than the equivalent figures as at 31 December 2017. The movement between September and December 2017 reflects normal run-off of the portfolio over the period.

6.19 As can be seen from Table 6.1 above, the “asbestos” segment dominates the portfolio, accounting for around two thirds of reserves. The EIROS and Timber & General segments include a number of underlying disease types but, in practice, these segments are also both dominated by asbestos claims. The “other non-disease and Profin” segment is in respect of claims on the 2005 and prior underwriting years that are not classified as “legacy”, and includes reserves in respect of PPO claims, reserves relating to professional indemnity and financial risk policies within the Profin book, as well as some disease claims, such as stress and repetitive strain injury claims that are not captured under “legacy”. The “other diseases” segment incorporates less significant disease types, with the majority of such claims being in respect of Vibration White Finger. The MIC segments include a significant amount of marine run-off business, which is dominated by US APH claims and aviation pools business, which is a mixture of APH and non-APH claims.

6.20 I discuss below my review of the reserves of the Transferring Business, focusing in particular on the asbestos segment, given its dominance of the portfolio.

Asbestos

6.21 Exposure to asbestos can lead to a number of diseases that often do not develop until many years after initial exposure. The most serious of these diseases is mesothelioma, a cancer of the lining of lung that, once diagnosed, is typically fatal within a matter of months. The latency period for this disease (i.e. the time between exposure and manifestation) is typically around 40 years or more. Asbestos exposure is also associated with other lung cancers and gives rise to other diseases such as asbestosis and pleural thickening. It can also cause pleural plaques, a non-malignant scarring of the lungs.

6.22 Exposure to asbestos often occurred in the workplace, and those affected by asbestos-related diseases often came into contact with asbestos during the course of their work. Therefore, many such individuals have brought compensation claims against their (often former) employer or employers. In many cases, this then leads to an insurance claim under the employer’s EL policy.

6.23 RSAI and its predecessor companies were significant players in the UK EL market through the middle and latter part of the 20th Century when most asbestos exposure took place and, therefore, have received considerable volumes of asbestos-related disease claims.

6.24 The unique nature of asbestos-related disease claims and the (often) long latency period associated with asbestos-related diseases creates particular difficulties for projecting future liabilities to such claims. An Institute and Faculty of Actuaries Working Party, known as the Asbestos Working Party (“AWP”), has carried out detailed research into the area of asbestos-related liabilities, and has produced a number of reports (most recently in 2009) on UK asbestos claims, which have included estimates of the insurance industry’s ultimate cost in respect of such claims. The AWP’s estimates have been based on models for the number of future deaths in the population relating to asbestos-related diseases. In particular, it has built on a model developed by the Health and Safety Executive (“HSE”) for the number of mesothelioma deaths in the UK population. This model suggests that the number of mesothelioma deaths is peaking around now (the period in which this Report was being drafted) and will tail off over the next 30 years or so. Given the long timescales over which asbestos-related deaths are expected to emerge, there is inevitably a significant degree of uncertainty around any estimate of future deaths and, in turn, future claim numbers.

6.25 The typical approach taken by actuaries to estimate liabilities relating to future UK asbestos claims is to use a frequency-severity model. A frequency-severity model estimates the number of future claims for each future period (i.e. the frequency) and the average cost of those claims in each future period (i.e. the severity). The product of the frequency and severity estimates in each future period is the expected cost of claims in that period. Summing the cost of claims over all future periods yields the total future claims cost.

- 6.26 RSAI has used a frequency-severity model in making its estimates of future UK asbestos claims. It projects the major asbestos disease types separately, although EL mesothelioma claims account for over 90% of estimated future asbestos liability. The reserves for asbestos claims set out in Table 6.1 above were based on a full review conducted by RSAI during the third quarter of 2017, based on data as at 30 June 2017 (I note that other reviews have been conducted in respect of asbestos claims subsequent to the 2017 year-end – I refer to these in paragraph 6.36 below). RSAI has provided me with documentation of the review undertaken as at 30 June 2017, as well as more recent developments. The asbestos liabilities of RSAI have also been the subject of review by external actuarial consultants, most recently as at 31 December 2014, and I have been provided with the report produced by those consultants as at that date. The methodologies used by RSAI internally in its recent reviews were consistent with those adopted by the external consultants previously.
- 6.27 A summary of the main assumptions used by RSAI in its projection of future EL mesothelioma claims is as follows:

Frequency

- RSAI estimated the current annual filing rate of mesothelioma claims based on the average number of claims reported over each quarter over the last 3 years.
- It then estimated the fraction of these claims that would settle for cost (i.e. some of the reported claims are deemed not valid and therefore are settled for no cost). The nil rate selection is based on the average ultimate nil rate estimated for quarterly claims cohorts over the last 3 years. As many of the claims reported in recent years have not yet settled, RSAI has used standard actuarial projection techniques to estimate the ultimate nil claims rate. In recent periods, RSAI has noted an increase in the nil rate, which has been factored into its selection.
- The selected filing rate and nil claims rate determine the expected number of non-nil claims to be filed in the next year. RSAI has then projected non-nil claims filings for subsequent years, assuming that the numbers progress pro-rata to the number of mesothelioma claims projected in the AWP model published in 2009.
- The AWP's model projects the future number of mesothelioma deaths by year and then estimates the fraction of these that will result in an insurance claim (claimant-to-death or CD ratio). The AWP considered five scenarios regarding how the CD ratio might change over time as it had observed that CD ratios appeared to have been increasing in the period before its last report in 2009. RSAI has based its future projection pattern on the average of four of the five scenarios. All of the scenarios considered CD ratios that either remain steady or increase over time to varying extents. RSAI has excluded the scenario exhibiting the most extreme increase in CD ratios from its average selection. However, as market data analysed by the AWP since 2009 suggests that CD ratios have not increased in recent years, the approach adopted by RSAI, which assumes an increasing CD ratio, could be considered conservative, although this is an area of great uncertainty.
- In using the AWP's frequency projections, RSAI has implicitly assumed that the exposures that give rise to the claims it faces are similar to those underlying the AWP model. This assumption is discussed by the external actuaries in their most recent report that reviewed the asbestos claims. The report mentions that there is limited information available relating to RSAI's claimants' potential exposure to asbestos, although some analyses had been undertaken on the average age of claimants and exposure dates of the claimants, as compared to the exposure assumed in the AWP model. The results of these analyses did not produce conclusive results to suggest that RSAI's exposures were materially different to those of the AWP model. There is some indication that RSAI's claimants might be slightly younger, on average, than those seen in the market as a whole, although both RSAI's data and that of the market as a whole are tending to suggest that claims numbers peaked around 2015. In other words, at this stage, there does not appear to be a lag between the peak in claim numbers received by the market and those received by RSAI, which might have been the case if the exposures were materially different.

Severity

- The insurance policies triggered by EL asbestos claims are those relating to the period of exposure. Claimants would often have been exposed to asbestos over a number of years, possibly during the course of employment with more than one employer. Therefore, damages payable to claimants are typically shared among a number of insurers, based on the length of time for which they were insuring the employer(s) during the exposure period. However, legally, each employer is jointly and severally liable for the indivisible injury that is mesothelioma. Therefore, claimants only have to find a single solvent liable employer and / or its insurer in order to recover 100% of their damages. Insurers so identified might initially have to pay 100% of the claim, but are able to seek contributions from other liable employers or their insurers. However, this may not be possible where exposure and/or insurance coverage is not traceable, and so one insurer might ultimately be liable for more than its time on risk share.
- RSAI's starting point for average claim costs (i.e. severities) is to estimate average damages on a 100% basis. RSAI does this based on averages of the 100% amount of claims over the last 3 years, having first projected the average amounts to ultimate and made an adjustment for inflation.
- RSAI then calculates its average time on risk share of the claim, based on the average of claims reported over the last 3 years.
- RSAI's share of untraced periods of cover is also estimated, based on averages seen in recent periods.
- In order to project the average claims costs forward in future years, RSAI has allowed for the different types of inflation that affect these claims. The damages awards to mesothelioma claimants comprise a number of components, the most significant of which are, typically, general damages (for pain and suffering, and loss of amenity) and special damages (compensation for any direct financial loss, such as loss of earnings or pension). Other components include legal costs, care expenses, funeral costs and a bereavement award where the claimant is already deceased. These components are subject to different types of inflation (in particular court award inflation, wage inflation, and general price inflation). RSAI has modelled future inflation allowing for an assumed split of the overall average cost between its component parts, and for applying the relevant rates of inflation. The approach is consistent with that used in the AWP's modelling of mesothelioma claims, although RSAI has used a lower rate of wage inflation than that selected by the AWP (3% rather than 4%). This does not appear unreasonable, given the actual rates of wage inflation seen in recent years.

6.28 With regard to claims that were already outstanding as at the valuation date, RSAI has undertaken an analysis showing the development of case reserves through to ultimate. This indicates that the incurred value of claims typically reduces over time (due to claims settling for less than case reserves), so RSAI holds a negative IBNR reserve in addition to case reserves for the reported claims.

6.29 For non-mesothelioma asbestos diseases (which, altogether, make up less than 10% of the provisions held for asbestos claims), RSAI has adopted a similar frequency-severity modelling approach, although the severities are modelled at the level of the RSAI share only (i.e. the more detailed approach of modelling the 100% costs and then taking account of time on risk and untraced share separately, as performed for the mesothelioma claims, is not undertaken). RSAI has also taken a more simplistic approach to inflation, having assumed a flat rate of future inflation of 3%. RSAI has used the future claim projection patterns developed by the AWP for its projection of future claims. The disease types modelled are: lung cancer, asbestosis, pleural thickening and pleural plaques.

6.30 The Transferring Business benefits from some external reinsurance, with much of the expected recoveries being in respect of the EL mesothelioma IBNR claims. RSAI has used a stochastic model to estimate future reinsurance recoveries. This involves simulating thousands of potential gross losses (using the gross assumptions described above as a mean of the distribution) and calculating the potential reinsurance recoveries for each scenario. The best estimate of recoveries can then be calculated as the mean of the simulated recoveries. A stochastic approach such as this is necessary, given the non-proportional nature of the excess of loss reinsurance contracts.

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- 6.31 RSAI's modelling of future reinsurance recoveries requires assumptions to be made regarding the years of exposure of the asbestos claims and, therefore, to which reinsurance treaties the claims attach. Treaties incepting after 1969 are noted as generally having higher deductibles and/or allowing for the indexation of retentions in line with national earnings. As a result, post-1969 treaties are in general less accessible than earlier treaties and most of RSAI's reinsurance asset is projected to come from pre-1969 treaties.
- 6.32 Based on my review of RSAI's reserves for asbestos claims, I am satisfied that they appear to be reasonable as at 31 December 2017, albeit that there is a high degree of uncertainty associated with any estimate of asbestos liabilities. The approach taken by RSAI (i.e. a frequency-severity model, utilising the work undertaken by the AWP) is in line with market practice for these types of claims. Having had a significant share of the EL market, RSAI receives large volumes of asbestos-related claims, and this has facilitated a detailed analysis of costs and trends that would not be feasible with a smaller portfolio. Having reviewed the main assumptions underlying RSAI's modelling of asbestos claims, I believe that the assumptions used are reasonable, although it should be noted that setting these assumptions does require a degree of judgement.
- 6.33 In order to illustrate the sensitivities of the results to the main selections, RSAI has prepared an exhibit that shows the impact of alternative reasonable selections on the main result, based on choosing assumptions over different averaging periods. The results of this exhibit vary by assumption, with adverse scenarios showing increases to the mesothelioma IBNR reserve of up to 6%, and favourable scenarios showing reductions to the mesothelioma IBNR reserve of up to 10%. RSAI has separately shown that the impact of reducing the inflation rate assumptions by 1 percentage point would be to reduce net IBNR by around 12%.
- 6.34 It has also shown the results implied by an alternative model that was considered by the AWP (known as the Nielsen model). The impact of the Nielsen model depends on its parameterisation; RSAI has considered a low and high scenario. The former would give rise to an increase in gross IBNR reserve of around 1% and the latter 9%. RSAI has further used the Nielsen model to assess the potential impact of allowing for claims from claimants over 90 years of age, which have been excluded from the AWP model due to sparsity of data relating to such claimants at the time of the previous AWP projections. In practice, RSAI has, to some extent, implicitly allowed for some claims from claimants aged 90 and over in its reserves, in that the starting point of its frequency projection is based on the average number of claims advised over recent years, and it has actually received some claims from people aged 90 and over (around 2% of claims on average over the past 3 years). However, as the AWP's future claim number patterns do not allow for claimants aged 90 and over, the future pattern of claim numbers used by RSAI may tail off more quickly than it otherwise would. The extent to which people aged over 90 years will make claims going forward is an area of significant uncertainty, as has been recognised by the AWP, although it is thought that any deficiency resulting from the assumptions regarding claimants aged 90 and over may be offset by areas of prudence elsewhere in the model (such as increasing CD ratios). Based on its estimates using the Nielsen model, RSAI assessed that the effect of allowing for claims from claimants aged 90 and over would be to increase its gross IBNR reserve by around 5%.

- 6.35 RSAI has additionally provided me with details of some developments since the completion of the full reserving exercise as at 30 June 2017. Subsequent to that reserving exercise, RSAI has updated its estimates to reflect an expected change in the Ogden Rate³⁷. The special damages component of mesothelioma awards would usually be in respect of lost pension income and this award is determined with reference to the Ogden tables (actuarial tables used to assess compensation awards based on the age and life expectancy of the claimant). Special damages are paid as a lump sum, with the amount paid being the net present value of the lost income. Assessing the net present value requires the use of a discount rate, effectively the real rate of return it is assumed a claimant (or their estate) could achieve by investing the lump sum. Following a long period of no change, in February 2017 the Lord Chancellor announced that the Ogden Rate would be reduced from 2.5% to -0.75%. This resulted in material increases in the provisions held by insurers in respect of outstanding liabilities that were likely to be settled by lump sum payments. RSAI had incorporated the full impact of the discount rate change into the reserves set following the full reserving exercise as at 30 June 2017. Subsequently the Ministry of Justice announced its intention to revise the process by which the Ogden rate is set and has recently introduced legislation in Parliament that, if enacted, is widely expected to lead to an increase in the Ogden rate, to between 0% and 1%. In response to this development, RSAI has adjusted its reserves for asbestos claims so as to allow for the Ogden rate to increase to 0% (subject to holding back a margin of one sixth of the resulting improvement in reserves). This led to modest favourable movement in its asbestos reserves as at 31 December 2017.
- 6.36 RSAI has also provided me with the results of an analysis it undertook regarding claims developments through to 31 March 2018. While RSAI has not yet adjusted its reserves as a result of this analysis, it appears to show, overall, favourable movements in the period since the previous review. These are due to the number of claims reported being less than expected and to favourable movement in the average cost of claims, although the nil rate is developing less favourably than expected for the 2017 year. RSAI has since conducted another full review of its asbestos claims, based on data as at 30 June 2018, and this shall form the basis for RSAI's asbestos claims reserves as at 31 December 2018. At this stage, I note that the results of this most recent review of the asbestos claims continue to show favourable movements. I shall comment further on the review in my Supplementary Report, when considering RSAI's claims reserves as at 31 December 2018.

Noise Induced Hearing Loss

- 6.37 RSAI reserves for the NIHL claims in-house. The reserve figures shown in Table 6.1 above are based on a review on data as at 30 September 2017. RSAI has subsequently undertaken a more recent review based on data as at 31 March 2018. Like many other insurers, RSAI saw a steep increase in claims notifications around 2011-2015, although volumes have started to reduce in the last few years. One of the reasons for the increase in claims numbers was the activities of claims management companies.
- 6.38 As with the asbestos claims, RSAI has adopted a frequency-severity approach to model NIHL claims. Unlike with asbestos, there are no industry projections of future NIHL claims or cases, and there remains a significant degree of uncertainty as to the extent to which future claims will emerge.
- 6.39 A large fraction of the reported NIHL claims ultimately settles for no cost. The proportion of claims that settle for nil cost appears to have increased, along with the increase in notifications seen in recent years. RSAI is projecting that over 70% of future claims will ultimately settle for no cost.
- 6.40 Any projection of future NIHL claim numbers is necessarily highly judgemental. RSAI has assumed that numbers reported will continue to decline steeply over the next couple of years before tailing off completely over the next 20 years or so. While such a projection is not out of line with other such projections that I have seen, there is a very high degree of uncertainty surrounding these estimates. In assessing sensitivities with its estimates, RSAI has considered a more pessimistic run-off pattern, which would increase the reserve in respect of future notifications by around 100%.

³⁷ The "Ogden Rate" is the colloquial term referring to the discount rate applied when evaluating lump sum payments in respect of personal injury claims. Currently, the Ogden Rate is reviewed and reset from time-to-time by the Lord Chancellor and is intended to reflect real rates of return to be earned on lump sum payments invested in low risk assets.

- 6.41 I note that the most recent review, as at 31 March 2018, gave rise to an increase in net reserves of around £8 million. This was driven, in particular, by the nil rate being less than expected and by savings on open claims being lower than expected.
- 6.42 The fraction of claims that will ultimately settle for nil cost is a key assumption. RSAI has set its assumption for all future claims based on experience over recent years. However, it is possible that nil rate claims will begin to reduce as claims volumes come down.
- 6.43 I consider the approach taken by RSAI in setting its reserves for NIHL claims to be reasonable and in line with market practice. However, given the assumptions selected, I believe it to be more likely than not that the ultimate value of NIHL claims will exceed those estimated by RSAI.

EIROS and Timber & General

- 6.44 RSAI has a 32.66% share of EIROS. EIROS has historically been subject to biennial external actuarial reviews (by the same firm of consultants that reviewed RSAI's main asbestos liabilities), with the most recent review having taken place based on 30 June 2015 data. I am informed that, in 2017, the EIROS Board decided to defer the actuarial review by twelve months because the experience since the previous review was broadly in line with expectations. RSAI expects to receive the results of the next external actuarial review (based on 30 June 2018 data) in late 2018/early 2019. RSAI performs actual versus expected analyses to monitor developments between reviews.
- 6.45 EIROS sees a variety of asbestos and NIHL claims, although EL mesothelioma claims are by far the most significant, accounting for over 70% of its reserves. The approach taken by the external actuaries to reserving for these claims follows the same lines as for RSAI's main portfolio as described above. The main difference in methodology is that the AWP model has been adjusted to reflect the earlier exposures of EIROS as compared to the market average, based on employee numbers during the course of the exposure period. There is no outwards reinsurance protecting EIROS.
- 6.46 RSAI assumes 100% of the Timber and General liabilities, but two thirds are ceded to external parties on a quota share basis. Like EIROS, the liabilities primarily relate to asbestos and NIHL claims, although they are dominated by mesothelioma EL claims. The portfolio was also previously evaluated by the same external actuaries up to 31 December 2014, but since then the reserving has been undertaken in-house by RSAI. The approach to reserving is similar to that described above.
- 6.47 I am satisfied that the methodologies employed in reserving for EIROS and Timber and General are appropriate and that the reserves for these portfolios appear reasonable as at 31 December 2017, noting (as above) the particular uncertainties associated with asbestos and other latent claims.

Abuse

- 6.48 As for NIHL claims, RSAI assesses in-house its reserves for abuse claims. Its most recent review was at 31 March 2018. The figures underlying the reserves as at 31 December 2017 were based on a review undertaken on data as at 30 September 2017, rolled forward.
- 6.49 RSAI has seen significant volumes of abuse claims emanating from schools, care homes and other institutions. It has recently seen a number of football-related claims, which gave rise to an increase in estimates of ultimate claims during 2017.
- 6.50 RSAI has taken a frequency-severity approach to projecting abuse claims. As with NIHL claims, there is a high degree of uncertainty concerning future claim numbers, which, as has been seen in recent experience, can be driven by media attention on historic abuse allegations. There is a high degree of judgement involved in any future claims estimates for abuse claims.
- 6.51 In June 2017, the Scottish government passed legislation (which came into effect in October 2017) that removes a time limit on victims of abuse bringing claims and, therefore, potentially allows for greater volumes of claims to emerge. The impact of this legislative change upon ultimate claims costs is uncertain, and RSAI has considered the possible impact on its reserves of a range of scenarios. As a result, as at 31 December 2017 it increased its reserve estimates for abuse claims by approximately £4 million.

- 6.52 I consider the approach taken by RSAI in setting its reserves for abuse claims to be reasonable. However, there is a very high degree of uncertainty regarding these claims and the ultimate outcome could differ materially from the estimates made by RSAI. I note that, in its most recent review as at 31 March 2018, RSAI found developments to have been favourable, overall, with reduced average cost experience and favourable prior-year development offsetting adverse experience with regard to claims volumes.

Other non-disease and Profin

- 6.53 The “other non-disease” segment is the remaining material segment relating to business written by RSAI that has not already been discussed above. This segment includes a mixture of claim types, including settled PPOs, professional indemnity and other liability claims. The PPO claims have been reserved based on cash-flow projections for each, accounting for the life expectancy of the claimant. The other classes have been projected using standard actuarial techniques. Given the maturity of these claims, there is a relatively little IBNR reserve projected relative to the amount outstanding.
- 6.54 Because of their lesser significance to the overall reserves, I have not examined the methodology and assumptions underlying the reserving for this business. However, based on my experience of reviewing reserves for similar business, the magnitude of the reserves for this business appears reasonable, and I see no reason to suspect that the reserves held for these claims as at 31 December 2017 could be misstated to a material degree.

Marine

- 6.55 The marine account is dominated by reserves in respect of the US asbestos claim Allied Signal. This claim is subject to a structured settlement with payments contingent on underlying claim payments by the assured reaching certain thresholds. The reserve held by MIC (and reinsured into RSAI) reflects the full amount that could be paid under the settlement. There are a number of treaty and facultative reinsurance protections covering the Allied Signal claim, which make up most of the expected reinsurance recoveries on this segment.
- 6.56 There are a number of smaller US asbestos assureds that fall into the marine segment, including Triple A Machine Shop, the reserves for which have recently been revised based on the claims experience of the assured.
- 6.57 There are also some exposures in this segment to direct US pollution claims and inwards reinsurance of US and London Market insurers. The reserves held for these claims are set using industry benchmarks, which appear to be reasonable for these exposures. I note that, subsequent to 31 December 2017, RSAI has increased its reserves for the direct pollution claims, following recent payments that were greater than expected. Overall, the marine segment saw an adverse impact of around £2.5 million.
- 6.58 Overall, I consider the held reserves for the marine segment to be reasonable as at 31 December 2017.

Aviation Pools

- 6.59 The remaining material component of the Transferring Business emanating from MIC is its participation in aviation pools, BAIG and LAIG, both of which are managed by GAUM. Net liabilities relating to BAIG are around twice as large as those of LAIG.
- 6.60 BAIG is subject to biannual external actuarial reviews. MIC participated on the pool between 1991 and 2003. Its liabilities relating to BAIG are a mixture of APH and non-APH losses. The aviation policies are unusual in that they did not have asbestos exclusions from around 1985, which was the case with most other liability insurance classes. Therefore, there is asbestos exposure throughout the period of MIC’s participation on the pool.
- 6.61 The external actuaries have used standard actuarial techniques to project the non-APH losses. There is little IBNR projected for the non-APH claims, which is to be expected given their maturity. The APH claims have been projected using benchmarks. Based on my experience of reserving for this type of business, I consider those benchmark factors to be not unreasonable. The resulting IBNR-to-outstanding ratios are high relative to those typically seen for APH portfolios. However, as noted by the external actuaries, there is particular uncertainty with these liabilities, resulting from the unusually late exposure periods.

6.62 The LAIG exposures are earlier (all pre-1990) and are mainly APH-related. Asbestos and pollution reserves were originally set based on the work of an external actuarial firm in 2011, and subsequently rolled forward, other than in respect of asbestos reinsurance liabilities, for which the reserves have been set judgmentally. The resulting survival ratios for this business appear to me to be not unreasonable.

Reserve Uncertainty

6.63 As has been highlighted above, there is considerable uncertainty associated with various aspects of the Transferring Business, and RSAI has identified the risks associated with the Transferring Business as being some of the key uncertainties facing its business as a whole. Particular sources of uncertainty relating to the Transferring Business include:

- The asbestos reserves are based on the projections made by the AWP, most recently in 2009. The AWP is expected to publish the results of updated projections in 2019. While data published by the AWP since its last model update does not suggest that experience in the period has varied excessively from expectations, to the extent that the AWP does revise materially its projections RSAI may likewise want to revise its unpaid claim estimates for asbestos. I note, in particular, that the AWP's projections until now have not included any projections relating to claimants over 90 years of age, or for claims to be made after 2050, and RSAI's reserves, likewise, do not allow for these. Were the AWP to allow for these in its next projection, this could have a material impact on RSAI's estimates. Such an impact could, however, be mitigated by other model changes such as claimant to death ratios, which appear to have been developing favourably recently.
- The Transferring Business can be impacted by legislative and regulatory change. This has been seen recently with regard to the Ogden Rate change and the change in the law in Scotland regarding the time limit of abuse claims. Future similar changes could occur and could potentially have a material impact on the reserves.
- The projections of future NIHL and abuse claim numbers are particularly uncertain, and the future pattern has been set subjectively. Unlike with asbestos, there are no industry-wide projections of these claims, and the forces driving such claims are not epidemiological in nature but are driven, at least in part, by factors such as the activities of claims management companies and media interest, which are difficult to predict or model. As such, it should be expected that the ultimate value of these claim types might vary significantly from the reserves current held.
- The long-tailed nature of the Transferring Business means that the claims are particularly exposed to changes in the inflation rate.

6.64 Other sources of uncertainty that RSAI has identified as affecting its reserves more generally include:

- Uncertainty around PPO claims, in particular the extent to which the courts award PPOs as opposed to lump-sum settlements. PPOs are typically more costly to settle than lump sum awards, given current investment conditions (although the reduction in the Ogden Rate has greatly reduced the difference in the costs). The value of PPO claims is also sensitive to changes in the discount rate used.
- RSAI is exposed to the potential emergence of new latent and industrial disease claims.
- Compensation culture and increasing awards – RSAI's claims reserves could be negatively affected if there were a continuation of these trends.
- RSAI has noted that it has changed its underwriting philosophy greatly in recent years, meaning that historical claim development patterns may not be applicable to business written more recently.
- RSAI has highlighted the inherent statistical uncertainty in its actuarial models.

- 6.65 RSAI's capital modelling team has made a quantitative assessment of the uncertainty inherent within the reserves of the Transferring Business, which estimates the value of the liabilities at a range of percentiles. The work underlying this analysis is consistent with RSAI's internal capital model, which it uses for calculating its SCR under Solvency II. For the main asbestos claim types, RSAI has modelled frequency and severity separately. Frequency is modelled stochastically around "low", "medium" and "high" scenarios estimated by the AWP. RSAI has set the variability of its simulations so as to be consistent with estimates made by external consultants. Severity is also modelled stochastically using a lognormal distribution, with the variability assessed based on historical experience. Non-asbestos claims have been modelled more simplistically using an aggregate lognormal distribution. The parameterisation of this modelling appears to be reasonable, although I note that there is inevitably a high degree of uncertainty associated with estimates of extreme outcomes in the distribution.

Solvency II Technical Provisions

- 6.66 Technical Provisions determined under Solvency II are conceptually valued on a market consistent basis, i.e. the amount a third party would want to be paid to assume the liabilities. They consist of three components: (1) a discounted best estimate claims provision for incurred claims (whether or not reported at the valuation date); (2) a discounted best estimate premium provision (comprising cash-flows from unearned premiums, both claim payments from future exposures and certain elements of future premiums); and (3) a risk margin calculated using a cost-of-capital approach. Appendix H provides further details on the calculation of Technical Provisions under Solvency II.
- 6.67 RSAI's starting point for calculating Technical Provisions on a Solvency II basis is the estimated GAAP reserves as described above. RSAI has provided me with documentation describing the process it has gone through and the adjustments it has made to calculate Technical Provisions on a Solvency II basis. The process and assumptions are fairly typical of those that I have seen adopted by other UK insurance companies.

Conclusion with regard to the reserve strength of RSAI pre- and post-Scheme

- 6.68 Based on my review of the technical provisions of RSAI (both on a GAAP and Solvency II basis), as described above as at 31 December 2017, I have concluded that the methodologies and major assumptions underlying the reserve analyses as performed by RSAI are reasonable, that the actuarial indications of unpaid claim amounts also appear reasonable, and that the reserves booked by RSAI as at 31 December 2017 include some margins, both implicit and explicit, over those actuarial indications. Therefore, I conclude that RSAI's reserves appear reasonable at present, notwithstanding the high degree of uncertainty present, particularly in the provisions relating to the Transferring Business.
- 6.69 After the Scheme is implemented, the net reserves of RSAI will be essentially unchanged as the Transferring Business is currently fully reinsured into Cavello Bay. The gross reserves will be reduced in respect of the Transferring Business, but those relating to the remaining business should not be affected by the Scheme. I have no reason to suppose that the reserve strength of RSAI will be affected by the Scheme.

RESERVE STRENGTH OF MIC (PRE- AND POST-SCHEME)

- 6.70 In its statutory accounts as at 31 December 2017, MIC held gross technical provisions of £39.4 million (made up of £23.2 million of unearned premium reserves and £16.2 million of outstanding claims reserves). As MIC is 100% reinsured by RSAI, reinsurers' share of the technical provisions was equal to the gross amounts³⁸. The accounts separately identified £75.7 million of additional technical provisions and corresponding reinsurers' share of technical provisions for disposal. These amounts were in respect of the MIC Transferring Business.

³⁸ In MIC's Annual Report as at 31 December 2017 there was a small but immaterial difference between the reinsurers' share of the technical provisions and the gross technical provisions.

- 6.71 The gross reserves of MIC will therefore reduce by almost 70% as a result of the Scheme, but the net reserves of MIC will be unchanged as its liabilities are already fully reinsured into RSAI. I have discussed above the main elements of MIC's liabilities that will transfer under the Scheme and have concluded that the reserves held appeared reasonable as at 31 December 2017.
- 6.72 The remaining gross reserves of MIC are in respect of Marine energy business written in the 2004 and subsequent underwriting years (much of which relates to renewable energy business) and other Marine business written in the 1997 and subsequent underwriting years.

Conclusion

- 6.73 Based on my review of RSAI's reserves (which includes the MIC liabilities that are 100% reinsured by RSAI), as described above, I conclude that the reserves of MIC appear reasonable as at 31 December 2017 and the reserve strength of MIC should not be materially affected by the Scheme.

RESERVE STRENGTH OF MERCANTILE (POST-SCHEME)

- 6.74 Until such time as the Transferring Business is transferred to it, Mercantile will have no insurance business and will therefore have no reserves.
- 6.75 Following the implementation of the Scheme, I am informed by EEUL management that it plans to recreate or migrate RSAI's actuarial reserving models for the commercial liability business (i.e. the business giving rise to the asbestos and other disease claims). An actuary with experience of developing and working with these models is expected to transfer from RSAI to EEUL and will help to support this process. I am also informed by EEUL management that reserve modelling for marine and aviation business will be performed using actuarial models that already exist within EEUL, subject to some minor updates to these models that might be required.
- 6.76 For the purpose of preparing the Regulatory Business Plan for Mercantile ("the Business Plan", the most recent version of which is dated 15 June 2018), including projections of future capital adequacy, and for calculating the level of reinsurance cover needed, the Enstar Group has used reserve figures calculated by RSAI without adjustment. I note that the reserve figures as at 31 December 2017 used by the Enstar Group in preparing the Business Plan are consistent with those shown in Table 6.1 above, which are based on RSAI's final view of the actuarial indications as at 31 December 2017.

Conclusion

- 6.77 My conclusions below with regard to the financial strength of Mercantile are based on the assumption that it adopts the same level of reserves as currently adopted by RSAI for the Transferring Business, which I have concluded above to have been set at a reasonable level as at 31 December 2017. The Enstar Group has indeed used reserve figures produced by RSAI for the purpose of its financial projections, which means that I can use these without adjustment (in regard to reserve strength) in order to make a fair comparison of the financial strength of Mercantile and RSAI.
- 6.78 After the transfer, Mercantile will set its reserves independently of RSAI, but I would not expect there to be a material change in the level of reserves it holds, as compared to those currently held by RSAI, given that:
- it is intending to adopt a similar approach to reserving as RSAI;
 - there is expected to be some continuity in personnel operating the reserving models; and,
 - for Solvency II purposes, it will calculate technical provisions on the same best estimate basis.

EXCESS ASSETS OF RSAI AND OF MIC

- 6.79 As stated in paragraph 4.44 above, RSAI and MIC have been approved to use the RSA Group Internal Model in order to calculate their SCRs. I have been provided with a report, entitled “*Group ORSA Report 2018*” and dated 20 June 2018, which contains a description of the RSA Group Internal Model used to calculate the SCR. It explains that the RSA Group prefers to use an internal model approach to calculating the SCRs for the entities within the RSA Group, rather than using the standard formula, as the RSA Group Internal Model better reflects:
- the international diversification of the RSA Group;
 - the diversification provided by using multiple distribution channels;
 - catastrophe risk in North America;
 - the risks associated with long-tailed covers; and
 - pension risk, which is not explicitly derived in the standard formula.
- 6.80 The report sets out in detail the results of the internal model calculations for RSAIG and for its insurance subsidiaries, including RSAI and MIC, and shows the projected SCRs for RSAIG and for its insurance subsidiaries for 2018, based on the financial positions of the different entities as at 31 December 2017.
- 6.81 The SCR for RSAI is assumed equal to the SCR of RSAIG, the ultimate parent of the RSA Group, as the two companies are economically equivalent: RSAI is the both the principal operating entity of the RSA Group, and has full beneficial ownership of the overseas entities, as well as RSA Re and MIC. This is illustrated in Appendix B.
- 6.82 The RSA Group Internal Model is used to calculate the SCR for RSAIG on two bases: one-year and to-ultimate.
- The one-year basis considers the expected variability over the current year in relation to both existing business and business to be written in the current year.
 - The to-ultimate basis considers the ultimate variability for the business to be written in the current year, as well as the variability in the current reserves.
 - In both cases the SCR is calculated to a one in 200 year confidence level.
- 6.83 Although the one-year basis only considers risk emergence over the forthcoming year, it benefits from just one year’s investment income and also includes a risk margin that must be established at the end of the year. On the other hand, the to-ultimate basis considers the emergence of all risks over the run-off of the business, but allows for investment income on assets in the run-off period ahead of an assumed reinsurance-to-close at the end of Year 12 (with the exception of the asbestos and disease claims for which the discounted true ultimate basis cash flows beyond Year 12 are used, rather than the closing Year 12 reserve with a reinsurance to close penalty). For RSAIG, the one-year SCR is greater than the to-ultimate SCR, implying that a large portion of the risk is expected to emerge over the first year, with far less risk emerging over the subsequent run-off of the business.
- 6.84 The RSA Group Internal Model does not generate to-ultimate SCRs for either RSAI or MIC. By implication, because RSAIG and RSAI are economically equivalent, the to-ultimate SCR for RSAI would be less than its SCR on a one-year basis. References hereafter to RSAI’s SCR or to MIC’s SCR refer to the SCRs on a one-year basis.
- 6.85 The most significant component of RSAI’s SCR is insurance risk, which RSAI considers in three parts:
- reserve risk, which is the risk relating to business that has been fully exposed as at the valuation date;
 - underwriting risk, which is the risk relating to business that has not been exposed as at the valuation date, specifically to the risk that claims experience (other than through catastrophes) for that business will differ from that planned; and
 - catastrophe risk, which is the risk that a single event (or series of events) of major magnitude, usually occurring over a short period, leads to a significant increase in actual claims compared to total expected claims.

6.86 The RSA Group also carries significant pensions risk, arising from its defined benefit pension obligations. This comprises the sub-risks of:

- Adverse movements of assets backing the pension liabilities;
- Decreases in interest rates leading to increases in liability values; and
- Increases in longevity or inflation increases in the cost of benefits.

Much of that risk resides in RSAI and much less in the other entities within the RSA Group.

6.87 Other material risk classes are operational risk (arising from such items as programme transformational change, legal or legislative non-compliance, data loss or corruption, etc.) and market risk (the risks around asset returns relative to the returns assumed in the discounting of reserves).

6.88 As all of MIC's insurance liabilities have already been transferred via reinsurance to RSAI, MIC has no insurance risk. Its risks comprise primarily credit default risk.

6.89 I have reviewed the work undertaken in estimating capital requirements for RSAI and MIC, as documented in the *Group ORSA Report 2018*, in order to satisfy myself that it is reasonable for me to rely on that work. This included reviewing the process by which capital estimates have been made, the approach followed by the RSA Group's modelling team, the key assumptions employed, and the resulting capital requirements generated by the team. Based on my review, I consider the methodology and modelling techniques used by the RSA Group to be in line with industry practice and generally appropriate. I note that a significant proportion of the investment assets of RSAI are in respect of subsidiary holdings and as such the assets are illiquid. The RSA Group's modelling team does not make an explicit allowance for this illiquidity within its assessment of RSAI's capital position, given that the fair value of the subsidiary holdings (£12.8 billion, as shown in RSAI's Annual Report as at 31 December 2017) materially exceeds the value recorded within the Solvency II economic balance sheet (£8.6 billion). Thus, the illiquidity of the subsidiary holdings is reflected within the excess assets over the liabilities and within the eligible own funds, and thus within the Capital Cover Ratio. I note that the capital estimates have been produced by suitably qualified actuaries (and other individuals) within the RSA Group, and that they have been reviewed and agreed by senior members of the RSA Group's modelling team. As a result, I believe it is reasonable for me to rely on the work of the RSA Group's modelling team, and therefore I have not attempted to review in detail the calculations performed by RSAIG in order to estimate the SCRs of RSAI and of MIC.

6.90 I have been provided with RSAI's QRTs as at 31 December 2017, which indicate that RSAI is well-capitalised relative to its SCR, with a Capital Cover Ratio of 187%. I have also seen RSAI's QRTs as at the end of the first quarter of 2018. This is not a public document so I cannot state its content in this Report, but I note that it indicates that RSAI remained well-capitalised as at 31 March 2018. I note in passing that, although RSAIG and RSAI are assumed to have identical SCRs, the eligible own funds in the two entities differ, due to various adjustments such as timing differences in the accrual of dividends, restrictions on the availability of capital at Group level e.g. deferred tax assets, etc. This results in RSAIG having less eligible own funds available to cover its SCR than does RSAI and hence its Capital Cover Ratio as at 31 December 2017 was lower than that of RSAI, at 163%. This indicated that RSAIG was well-capitalised as at 31 December 2017.

6.91 I have been provided with MIC's QRTs as at 31 December 2017, which indicate that MIC is very well-capitalised relative to its SCR, with a Capital Cover Ratio of 541%. I have also seen MIC's QRTs as at the end of the first quarter of 2018. This is not a public document so I cannot state its content in this Report, but I note that it indicates that MIC remained very well-capitalised as at 31 March 2018.

- 6.92 The RSA Group recently commissioned an independent review of the RSA Group Internal Model, given the changes to the business of the RSA Group through sales, portfolio transfers, de-risking of pension assets and general restructuring over the period since the RSA Group Internal Model was originally built and approved. The review was completed in March 2018. I am informed that the external consultants that undertook the review concluded that the level of the Group SCR was broadly reasonable, but they made a number of observations and suggestions for enhancements to the model that they estimated could, in aggregate, increase the SCR for RSAIG by around 4.5%. As the SCR for RSAI is assumed to be identical to that of RSAIG, I believe that the suggested changes could also, in aggregate, increase the SCR for RSAI by around 4.5%, but they are unlikely to affect the MIC SCR to a material degree. RSAIG and RSAI included a model add-on in their SCRs as at 31 December 2017, in order to address these observations and suggestions.
- 6.93 The RSA Group has now set about making changes to its model to address the observations made in the review. I am informed that the main areas to be addressed are related to correlations between reserve and underwriting risk, and the approach taken to risk emergence. I am informed that the changes are not expected to impact the modelling of standalone ultimate reserve risk or the level of reserve uncertainty of the Transferring Business.

Conclusion

- 6.94 I have explained above why I consider that the RSA Group's calculations and projections of RSAIG's (and RSAI's and MIC's) solvency requirements and available capital, and hence of its excess assets, are reasonable. Overall, these lead me to conclude that:
- the policyholders of RSAI, including those who will transfer under the proposed Scheme, currently benefit from the financial strength provided by a well-capitalised company; and
 - the policyholders of MIC, including those who will transfer under the proposed Scheme, currently benefit from the financial strength provided by a very well-capitalised company.

EXCESS ASSETS OF MERCANTILE

- 6.95 EEUL has made projections of Mercantile's balance sheets and solvency capital requirements, as contained in the Business Plan. The starting point of the financial projections in the Business Plan is the position as at 31 December 2017, and projections are made for each subsequent year-end through to 31 December 2022. The figures as at each date are on the basis that the Transferring Business had already been transferred into Mercantile.
- 6.96 The Business Plan projections show the balance sheet on GAAP, Solvency II and Own Economic Capital Assessment ("OECA") bases, and capital requirements on both Solvency II and OECA bases. The projections are prepared on the basis that additional capital had been injected into Mercantile such that its solvency ratio as at 31 December 2017, relative to its SCR as at the same date and calculated using the standard formula, would have been 130%.
- 6.97 The GAAP Business Plan projections are premised on the value of the Transferring Business as at 31 December 2017 being equal to the amounts calculated by RSAI as at that date. The projections assume that the reserves will decrease over time in accordance with projected cash-flows, without any surplus or deficit emerging.
- 6.98 The projected Solvency II Technical Provisions are based on the GAAP provisions, but incorporate a number of adjustments to make them consistent with the requirements of Solvency II. In particular, loadings have been added for ENIDs (based on the results of stochastic modelling undertaken by RSAI of the Transferring Business) and for expenses (based on a projection of expected expenses to ultimate for the portfolio). The reserves have also been discounted for the time value of money according to the appropriate risk-free yield curves. The Solvency II Technical Provisions also incorporate a risk margin, which has been calculated using a cost of capital approach based on the run-off of the SCR over time.
- 6.99 The Solvency II capital projections are based on the standard formula approach to calculating the SCR. EEUL has provided me with a spreadsheet detailing this calculation. The main components of the SCR are reserve risk, market risk, counterparty default risk and operational risk. This is consistent with the risk profile for Mercantile, as described in Section 4 above.

- 6.100 Market risk is the largest risk charge in the SCR calculation. This risk charge relates to the uncertainties inherent in the assets held by Mercantile. As at the time of me drafting this Report, the precise details of the investment portfolio that Mercantile will hold after the Scheme is effected are not known, although the Business Plan does specify investment guidelines and the make-up, by major asset type and rating, of a proxy portfolio. In the absence of exact details of the investment portfolio, EEUL has approximated its market risk charge by setting it as a percentage of the value of the investments in the balance sheet, where the percentage has been selected with reference to another company in the Enstar Group with a similar liability profile and investment guidelines, as well as to the proxy portfolio specified in the Business Plan. The results from the other company within the Enstar Group and that implied by the proxy portfolio are used to estimate the spread and equity risk charges for Mercantile, and both give similar results. An average of the two sets of charges has been taken with the average being weighted according to the approximate split of the assets between free assets and those backing the reserves. It is Mercantile's intention to minimise other market risk charges (i.e. concentration, currency and interest rate risks). The investment risk charge in the SCR calculation includes a small addition to allow for any residual exposures to these risk types. I am satisfied that EEUL's approach to calculating the market risk charge is reasonable and that the calculated market risk charge included that has been included in the SCR for Mercantile is also reasonable.
- 6.101 Reserve risk gives rise to the next largest risk charge in the SCR calculation, being just slightly less than the market risk charge. The reserve risk charge relates to the reserves that are retained in Mercantile and not ceded to Cavello Bay. EEUL has treated all of the RSAI Transferring Business as "third party liability" business and the MIC Transferring Business as "non-proportional reinsurance – casualty" business, and has then applied the standard multipliers to these lines of business to calculate the reserve risk charge. I note that splitting the business in this way is likely to be slightly conservative in that not all of the MIC Transferring Business is inwards reinsurance business (rather some is direct third party liability business) and the "non-proportional reinsurance – casualty" line attracts a greater charge in the calculation.
- 6.102 The SCR also includes a (relatively smaller) charge for counterparty default risk. As referred to in paragraph 4.100 above, the amount of funds held as collateral to support the reinsurance agreement with Cavello Bay has been set at a level such that there is no counterparty default risk charge relating to this reinsurance. I note that the counterparty default charge calculation in respect of the Cavello Bay reinsurance allows for market risk relating to the collateral held. This is done approximately, based on the make-up of the proxy portfolio detailed in Mercantile's Business Plan. The remaining counterparty risk charge relates to third party reinsurance contracts and investments/cash held by Mercantile. I note that, while the Cavello Bay reinsurance will pick up any bad debt relating to the third party reinsurance, this is not reflected in the counterparty default charge. Hence, the counterparty default charge is slightly conservative.
- 6.103 The final component of the SCR is the operational risk charge, which, under the standard formula approach, is taken to be the lesser of 3% of gross best estimate Technical Provisions and 30% of the basic SCR (i.e. the SCR before allowing for operational risk). For Mercantile, 3% of gross best estimate Technical Provisions is equivalent to about 25% of the basic SCR and so this value forms the operational risk charge.
- 6.104 As noted above, the Business Plan projections are based on sufficient capital being injected into Mercantile such that its Capital Cover Ratio (relative to the standard formula SCR) would be 130% at the start of the projection period. EEUL has projected Mercantile's Capital Cover Ratio to increase gradually over time, up to 187% as at 31 December 2022. This projection is based on the SCR reducing over time as the reserves run off. The projection assumes that the net assets on a GAAP basis will not change over the period, but that the difference between Solvency II own funds and GAAP net assets (the former being less due to the inclusion of the risk margin, ENIDs and expenses within the Technical Provisions) will reduce over the period, proportionate to the reduction in Technical Provisions.

- 6.105 Mercantile's OECA projections are based on assumptions that differ quite significantly from those underlying the Solvency II projections. For Mercantile's OECA balance sheet, EEUL has not included ENIDs or a risk margin in the technical provisions, although the technical provisions are discounted for the time value of money and include an allowance for expenses. This gives rise to a materially greater level of excess assets than on the Solvency II basis. However, the OECA includes a significantly greater reserve risk charge than is included in the SCR. The OECA reserve risk charge is based on a 97.5th percentile to ultimate confidence level (this contrasts to the 99.5th percentile over a one-year period under the standard formula SCR). To calculate the OECA reserve risk charge, EEUL has used the results of stochastic modelling undertaken by RSAI relating to the Transferring Business (as described in paragraph 6.65). The reserve risk charge is calculated using an uplift factor based on the 97.5th percentile outcome from RSA's modelling (on a basis including ENIDS) divided by the technical provisions on an excluding ENIDs basis. The factor is applied to the technical provision figures used in Mercantile's OECA balance sheet.
- 6.106 The counterparty default risk charge within the OECA has been also been set in a fundamentally different way to that in the SCR. In the SCR, the counterparty default risk charge relates to the chance of default by external reinsurers and banks at which cash is held (with the collateral amount being set such that the Cavello Bay reinsurance does not attract a default charge). Under the OECA, EEUL has allowed for the chance of default by external reinsurers, using a stochastic modelling approach, which gives rise to a default charge that is slightly greater than that under the SCR. EEUL has not included a charge relating to the cash holdings (on the basis, I am informed, that cash can more easily be reallocated to different banks in the event that a bank's security appears to be compromised or its rating reduces). However, it has included a loading relating to the likelihood of the collateral proving to be insufficient in the event of a default by Cavello Bay. It has assumed that the likelihood of Cavello Bay's default is equivalent to that of a company with an A credit rating (which appears reasonable to me given the intended solvency ratio of Cavello Bay), with the likelihood of default increasing over time in accordance with a company with such a rating. In calculating the latter, EEUL has run a series of stochastic simulations under several different scenarios that specify the point at which a reserve deterioration occurs. The choice of the scenarios is quite subjective, and the likelihood of each scenario is given equal weight. The only scenario considered that resulted in the collateral being exceeded at a 97.5th percentile confidence interval was when the reserve deterioration occurred late in the run-off period (equal deteriorations occurring after 10, 20 and 30 years). In practice, I would expect that deteriorations of a particular absolute amount would be more likely to occur earlier rather than later in the run-off period. This is not reflected in the calculation and, as such, the charge calculated by EEUL may be somewhat conservative, albeit that it is not a material part of the overall OECA. However, I believe that it is appropriate to make a counterparty default charge relating to the cash holdings. If an amount equivalent to that used in the SCR were included, it would not cause a material increase in the overall OECA.
- 6.107 The other two components of the OECA relate to market risk and to operational risk. The charges in the OECA for both of these risks have been set equal to those in the SCR calculation.
- 6.108 The results of the OECA projections show that Mercantile would have had a Capital Cover Ratio of 128% as at 31 December 2017, had the Transferring Business been transferred to Mercantile at that time, and had Mercantile been capitalised so as to have a 130% Capital Cover Ratio relative to its standard formula SCR as at 31 December 2017. The projections show that Mercantile's OECA Capital Cover Ratio would be expected to increase over time (to 165% by 31 December 2022), based on a similar approach and assumptions as underlying the projection of the Capital Cover Ratio for the SCR (see paragraph 6.104 above).

- 6.109 I have reviewed the Business Plan projections and the underlying calculations provided by EEUL and I believe the results to be broadly reasonable, subject to my comments above. I note that, as the standard formula is a “one size fits all” approach to calculating the SCR, it should be considered whether the risk profile of Mercantile deviates significantly from that underlying the assumptions of the standard formula and therefore whether the standard formula is appropriate for Mercantile. In relation to insurance risk, the make-up of the liabilities of the Transferring Business (being dominated by asbestos and other disease claims) is not a typical portfolio of third party liability claims. Also, given that Mercantile is in run-off and that the run-off is expected to take many years, it is arguable whether assessing the reserve risk at a 99.5th percentile confidence interval over a one-year time horizon is entirely appropriate. The approach taken in the OECA (i.e. 97.5th percentile to ultimate) is perhaps more suitable and is consistent with the confidence interval typically used by insurers in run-off for assessing their solvency requirements, prior to the introduction of Solvency II. The OECA reserve risk charge is based on stochastic modelling performed by RSAI (and used within its own SCR internal model) specifically for the Transferring Business, rather than generic factors in the standard formula. While the risk charge in the OECA is significantly greater than in the SCR, it should be borne in mind that the Solvency II balance sheet includes the risk margin (which is not included in the OECA balance sheet). If the technical provisions are taken together with the corresponding reserve risk charge, the total is in fact slightly greater under the Solvency II SCR basis than the OECA. This suggests that the technical provisions and reserve risk charge under the SCR will be sufficient at a 97.5% confidence interval on an ultimate basis (which I note, as per the modelling undertaken by RSAI, is a slightly stronger basis than 99.5th percentile over one year). On this basis, I am satisfied that the reserve risk charge under the SCR is reasonable. I also note that EEUL has made its own assessment of the appropriateness of the standard formula’s reserve risk charge and came to a similar conclusion.
- 6.110 The other main risk charges under the SCR are market and operational risk. Given the nature of the assets in which Mercantile is intending to invest, I have no reason to think that the market risk charge under the SCR would be inappropriate. Likewise, I have no reason to believe that the operational risk charge, as calculated, is unreasonable.
- 6.111 I note that, notwithstanding the above calculations, the financial security of Mercantile and hence of the Transferring Policyholders is heavily dependent on the operation of the Reinsurance Agreement (as amended with effect from the Effective Date). I will discuss later in this Section of the Report the excess assets of Cavello Bay (the reinsurer under the Reinsurance Agreement), but I note here that I gain additional comfort that the Reinsurance Agreement will operate as intended through: (1) the agreement to maintain collateral at a certain level relative to the outstanding liabilities, and (2) the EGL guarantee. I discuss these matters further later in this Section of the Report.

Conclusion

- 6.112 Based on my review of the projected excess assets of Mercantile for the period between 31 December 2017 and 31 December 2022, as described above, I believe that, upon receiving the Transferring Business and assuming that (1) it has already received the capital injection underlying the Business Plan and (2) the appropriate level of collateral is maintained in respect of the Reinsurance Agreement, Mercantile will be a more than sufficiently capitalised company and its capitalisation is expected to strengthen during the projection period.

EXCESS ASSETS OF CAVELLO BAY

- 6.113 While not directly party to the Scheme, I have considered the excess assets and solvency position of Cavello Bay, given that 75% of the Transferring Business will be ceded to it by Mercantile following the implementation of the Scheme.
- 6.114 As a Bermuda-domiciled company, Cavello Bay must satisfy the ECR in accordance with regulations promulgated by the BMA (see paragraph 3.50 onwards above). The Enstar Group has provided me with details of its latest solvency calculations for Cavello Bay, as contained in its CISSA for the year-end 31 December 2017. As noted in paragraph 4.130 above, subsequent to 31 December 2017, Cavello Bay has entered into two additional reinsurance transactions (the reinsurance of the CTP business of an Australian subsidiary of Zurich and the reinsurance of business originally assumed by San Francisco Reinsurance Company (subject to regulatory approval of this reinsurance being novated from Fitzwilliam)). The CISSA includes an allowance for these two transactions on a pro forma basis.

- 6.115 The figures provided show that, on a pro forma basis as at 31 December 2017, Cavello Bay's economic balance sheet had assets in excess of liabilities of approximately US\$1,161 million and a capital requirement of US\$625 million, implying a Capital Cover Ratio of 186%. Therefore, based on this measure, Cavello Bay could have been considered to be well-capitalised as at 31 December 2017.
- 6.116 I have received projections of Cavello Bay's economic balance sheet and solvency requirements as at the end of years 2017-2022 (based on known transactions involving Cavello Bay, including the Scheme, but not anticipating any further transactions). These projections do not allow for the emergence over time of any retained profit but they still show the Capital Cover Ratio increasing, as the reinsured liabilities run-off and as the portfolio hence gets de-risked. Therefore, all other things being equal, I would expect the level of security provided to Mercantile by Cavello Bay's reinsurance of 75% of its liabilities to increase over time.
- 6.117 I note that, based on balance sheets as at 31 December 2017, the liabilities within Cavello Bay, post-Scheme, will broadly comprise the following:

Table 6.2
Composition of Cavello Bay's Liabilities Post-Scheme

UK Employers' Liability	46%
Australian Motor	16%
US Workers' Compensation	19%
US Asbestos/Environmental	9%
US Other (General Liab/Property)	10%
TOTAL	100%

- 6.118 The UK Employers' Liability business comprises primarily the Transferring Business. As it contains material amounts of asbestos-related claims it would have some correlation with the portfolio of US asbestos claims, although differences in the underlying covers and in the legal environment mitigate that correlation. There is little obvious correlation between any of the other portfolios, save in respect of the impact of global economic conditions.

RELATIVE FINANCIAL STRENGTH ENJOYED BY TRANSFERRING POLICYHOLDERS PRE- AND POST-SCHEME

- 6.119 I have concluded above that the RSAI Transferring Policyholders currently benefit from the financial strength provided by a well-capitalised company and that the MIC Transferring Policyholders currently benefit from the financial strength provided by a very well-capitalised company. I have also concluded that, if the Scheme is implemented, the Transferring Policyholders will become policyholders of a more than sufficiently capitalised company. Therefore, relative to the solvency capital requirements of the respective entities, the Transferring Policyholders will see a weakening in the financial strength afforded to them. The RSAI Transferring Policyholders will also be moving from a large insurance company with excess assets of around £8 billion (based on the statutory accounts of RSAI as at 31 December 2017), to a much smaller company, which is expected to have excess assets of around £257.9 million (based on the projected GAAP balance sheets of Mercantile following the sanctioning of the Scheme). While they will be moving from a smaller company, with excess assets as at 31 December 2017 of £50 million, the MIC Transferring Policyholders currently benefit from the additional protection of their policies being 100% reinsured by RSAI. Therefore, it is clear to me that the security of benefits of the Transferring Policyholders will be diminished through differences in the relative financial strength of Mercantile post-Scheme, relative to RSAI and MIC pre-Scheme. I therefore discuss below whether or not this diminution is material.
- 6.120 The Transferring Policyholders currently benefit from the reinsurance provided by Cavello Bay. However, if this reinsurance cover proved to be inadequate, or if Cavello Bay defaulted on the reinsurance and then EGL failed to fulfil its obligations under the terms of its guarantee of the Reinsurance Agreement, then the policyholders would continue to benefit from the significant additional resources of RSAI. After the Scheme is implemented, the Transferring Policyholders would become more reliant on the reinsurance provided by Cavello Bay as a source of security, given that the excess assets of Mercantile, while providing some additional protection, are far more limited than those of RSAI.

- 6.121 In the event that the full limit of the reinsurance were exhausted, the Transferring Policyholders would be worse off after the Scheme is implemented than they are currently, given the much smaller amount of excess assets in Mercantile as compared to RSAI. However, if the Scheme is sanctioned, the Reinsurance Agreement will be amended such that the upper limit of cover available will be sufficient to cover 75% of losses of up to a 99.5% confidence level to ultimate (about £1.5 billion, as shown in Figure 5.1 above). As such, I consider the likelihood of losses exceeding the reinsurance to be very remote. However, I note that, in the event that losses deteriorate to the extent that the reinsurance is exhausted, it is likely that Mercantile would have insufficient funds to be able to pay the 25% of losses it retains. In this scenario, it would likely need to call upon the EGL guarantee to be able to meet its obligations.
- 6.122 If the Scheme is implemented then the Reinsurance Agreement (as amended) will be collateralised at a level to ensure that Mercantile has no counterparty default risk charge in its standard formula SCR, with the amount of collateral being revised on a quarterly basis (based on a full annual calculation and then quarterly roll-forward estimates, until the next full annual calculation). This means that the collateral held is expected to be more than adequate to pay for 75% of the net liabilities of the Transferring Business at a 99.5% confidence interval over a one-year time horizon. Based on modelling undertaken by RSAI, this is currently equivalent to a confidence level of roughly 85% on a to-ultimate basis – over time, the confidence level on a to-ultimate basis would be expected to trend into that on a one-year basis as the business runs off. Therefore, the collateral should be adequate to pay for future claims in the majority of scenarios.
- 6.123 In the event that the collateral proved to be inadequate, under the terms of the Reinsurance Agreement, Cavello Bay would provide additional (uncollateralised) cover of a further £758 million, up to the limit of £1,544 million (based on estimates of the upper limit as at 31 December 2017). As noted above, in its CISSA, Cavello Bay reported excess assets of US\$1,161 million (approximately £900 million) and assets in excess of its ECR of US\$536 million (or approximately £412 million). Therefore, Cavello Bay's ability to meet any claims to the Reinsurance Agreement over and above the initial collateralised amount, without compromising its own solvency, would be limited in more extreme scenarios. The Reinsurance Agreement might also be competing with other covers provided by Cavello Bay if the liabilities that they cover have also suffered extreme deterioration. However, Cavello Bay's obligations under the Reinsurance Agreement are guaranteed by EGL. In the event of a significant deterioration in the claims experience of the Transferring Business, Mercantile would likely be reliant upon the terms of the guarantee from EGL in order for Cavello Bay to be able to meet its obligations under the Reinsurance Agreement.
- 6.124 I have considered EGL's ability to meet its obligations under the terms of its guarantee in respect of the reinsurance of the Transferring Business. In its GSSA for the year ended 31 December 2017, EGL reported available capital of US\$2.9 billion (approximately £2.2 billion) against a BSCR of US\$1.7 billion (approximately £1.3 billion), giving a Capital Cover Ratio of approximately 170% and free assets over and above the capital requirement of approximately US\$1.2 billion (£0.9 billion). I note that, although EGL made a net loss of US\$33 million in the six months to 30 June 2018, in June 2018 it raised additional capital totalling US\$400 million through the issuance of depositary shares. Therefore, there are significant excess assets within EGL to meet the terms of the guarantee, should this be required.
- 6.125 I note that the Enstar Group has made other guarantees totalling more than US\$940 million. The fair value of each of these guarantees is small, reflecting the small likelihood of the guarantee being triggered. The guarantees are spread across a range of businesses and portfolios within the Enstar Group. While there is likely to be some correlation between these businesses and portfolios (i.e. if one portfolio suffers severely worsened claims experience then there is a high probability that another portfolio will suffer a similarly severely worsened claims experience) they are far from being fully correlated with one another. Therefore, while the likelihood of any of the guarantees being triggered is small, the likelihood of all being triggered is very remote.
- 6.126 In order to assess the ability of Mercantile (as well as Cavello Bay and EGL, through the Reinsurance Agreement and guarantee respectively) to meet the liabilities of the Transferring Business in the event of adverse circumstances, I have considered a number of stress scenarios as set out below.

6.127 **Stress 1: deterioration in the net claims liabilities of the Transferring Business by 100%.** As shown in Table 6.1 above, the net (of external reinsurance) liabilities of the Transferring Business as at 31 December 2017 were estimated to be approximately £787.4 million on an undiscounted basis. In addition to this, EEUL has estimated the expenses to be incurred in running off the business will total around £43.2 million. Therefore, (allowing for rounding) the total undiscounted cost of the liabilities is estimated as being £830.7 million. In this stress scenario I consider the possibility of the ultimate cost of running off the Transferring Business deteriorating by 100%, i.e. to £1,661.4 million. I note that I would consider this to be an extreme and unlikely scenario. Modelling undertaken by RSAI suggests that a deterioration of this order of magnitude would be consistent with the 97.5th percentile (on an ultimate basis) of the range of possible outcomes.

Under the Reinsurance Agreement (as amended), Mercantile will cede 75% of the liabilities of the Transferring Business to Cavello Bay. Therefore, in this scenario, Mercantile would cede £1,246.1 million (75% of £1,661.4 million) to Cavello Bay. The limit of the Reinsurance Agreement, based on figures as at 31 December 2017, is expected to be approximately £1,500 million. Therefore, losses of a magnitude considered in this scenario would not exceed the limit of the Reinsurance Agreement.

This stress would cause the retained net reserves of Mercantile to increase by about £208 million (i.e. 25% of £830.7 million). Mercantile's GAAP pro forma balance sheet as at 31 December 2017 (see Table 5.3 above) shows net assets of £257.9 million (this would drop to about £247 million if an explicit reserve for expenses were included). On this basis, Mercantile would have sufficient funds to pay its retained share of the losses, even in this stressed scenario. If Cavello Bay remained able to meet its obligations under the Reinsurance Agreement, then Mercantile should continue to be solvent, albeit that its net assets would be significantly diminished and that, without parental assistance, it would be unable to meet its solvency capital requirements and probably also its minimum capital requirements.

I note that, were this scenario to occur, the reserves would be unlikely to deteriorate to this extent immediately, and the claim payments would also not need to be made immediately. Therefore, Mercantile would potentially benefit from investment income on the assets backing the reserves and capital held through to the time of settlement of the claims. As such, its ultimate ability to fund claims in this scenario may be better than suggested by the figures given above.

In this scenario, Cavello Bay would also suffer an increase in reserves of around £623 million (i.e. 75% of £830.7 million), on an undiscounted basis. The post-Scheme pro forma balance sheet for Cavello Bay, as at 31 December 2017 (see Table 5.4 above), shows shareholder's equity of \$1,377 million – equivalent to just over £1,000 million. I note that Cavello Bay reports its reserves on a discounted basis. On a discounted basis, the increase in reserves in the scenario considered would be around £500 million. Therefore, the reserve increase seen in this scenario would be likely to reduce the shareholders' funds of Cavello Bay to around £500 million. As discussed in paragraph 6.118 above, there is little correlation between the portfolios reinsured by Cavello Bay, other than between the reinsurance of the Transferring Business and the small amounts of (US) asbestos liabilities also covered by Cavello Bay. While it is probable that a higher degree of correlation between the portfolios would develop in more extreme circumstances (for example, extreme global inflation), given the size of the Transferring Business relative to the other portfolios, I do not think it likely that the deterioration in reserves of these other portfolios would be as great as that of the Transferring Business. Therefore, I consider it likely that, in this scenario, Cavello Bay would remain solvent. Nevertheless, I believe that, in this scenario, Cavello Bay would fail to meet its solvency capital requirements in Bermuda (its surplus over regulatory capital, as at 31 December 2017, being just over £400 million).

This scenario would also impact EGL, due to the reduced net assets associated with its subsidiary firms. We would expect to see a deterioration in EGL's net assets equal to the total increase in reserves. EGL reported net assets as at 31 December 2017 of approximately \$3.1 billion (about £2.5 billion), based on figures in its annual report and accounts, which are premised on discounted reserve figures. Therefore, the reserve stress considered here, of £830 million (roughly £700 million on a discounted basis), would reduce EGL's shareholders' equity by about one third. In its GSSA as at 31 December 2017, EGL reported a surplus over its BSCR of around \$1.2 billion (about £0.9 billion). Therefore, the reserve stress would diminish this surplus by around 75%, but would not, in itself, cause EGL to fail to meet its solvency capital requirements. However, I note again that, in extreme conditions, the underlying portfolios in other parts of the Enstar Group might be correlated with those in Mercantile and Cavello Bay and that, in this scenario, those other parts of the Enstar Group may also be suffering from reserve deteriorations. Consequently, EGL shareholders' equity could be further diminished.

6.128 **Stress 2: fall in asset values.** For this stress scenario, I have considered the impact of a financial crisis that would cause the investment portfolios of Mercantile, Cavello Bay and the Enstar Group to fall in value by 20%. While different asset classes are more exposed to falls in value than others, and the investment portfolios of Mercantile, Cavello Bay and the Enstar Group are not identical (although they are all heavily weighted towards highly rated corporate and government debt), in the interests of simplicity I have selected 20% as a stress factor that I believe gives a suitably severe stress that is appropriate for illustrating the potential impact of a financial crisis on the companies concerned.

I note that the proxy investment portfolio specified in Mercantile's Business Plan shows that around 80% of Mercantile's assets will be invested in bonds (the vast majority with a high credit rating) and about 10% each in equities and structured products. Using this asset allocation, EEUL has estimated that the equity and spread risk charges applicable to the portfolio in the standard formula SCR calculation would be around 17% - i.e. less than the 20% stress considered here.

According to its pro forma balance sheet as at 31 December 2017 (see Table 5.3 above), Mercantile would have held investments of £407 million, which would mainly comprise a variety of debt and equity investments. In the event of this stress scenario, Mercantile would suffer a loss of just over £80 million. This would reduce Mercantile's net assets (on a GAAP basis) by almost a third, but would leave Mercantile solvent, albeit unable to meet its solvency capital requirements. The value of the collateral under the Reinsurance Agreement, which is expected to be invested mainly in bonds and equities, would reduce in value from around £786 million to £629 million. Assuming that reserve levels were unaffected, the collateral would then be roughly equal to the expected value of the claims ceded under the reinsurance, and Mercantile would, therefore, be more reliant on Cavello Bay remaining solvent in order to receive its contractual benefits under the reinsurance.

As at 31 December 2017, Cavello Bay's pro forma balance sheet (Table 5.4 above) shows total assets of \$3.6 billion. Of this, \$1.9 billion comprised investments, \$0.1 billion cash, £0.6 billion reinsurance recoverables, \$0.4 billion funds held relating to reinsured business, \$0.3 billion investments in other companies and \$0.2 billion of other assets and amounts due from related parties. Including the funds held and investments in other companies, the total amount of assets subject to the stress would be around \$2.6 billion. Thus, the stress would cause a loss of around \$0.5 billion, which is slightly more than one third of Cavello Bay's shareholder's funds of \$1.4 billion. Therefore, the stress would lead to a significant reduction in Cavello Bay's shareholder's funds, but would not, by itself, cause Cavello Bay's insolvency, and thus should not impinge on its ability to meet its contractual obligations to Mercantile.

EGL's balance sheet as at 31 December 2017 shows total investments of \$7.2 billion held mainly in bonds, but also including some equity investments and investments in various funds. In addition, EGL's balance sheet shows directly managed funds of \$1.2 billion (such amounts supporting specific reinsurance contracts), which were invested mainly in bonds. The balance sheet shows shareholders' equity of \$3.1 billion. The stress scenario would potentially reduce EGL's shareholders' equity by over 50%, meaning that it would no longer be able to meet its solvency capital requirements, and that it would be unlikely to be able to provide further support to Cavello Bay or Mercantile, although, as discussed above, it appears that the stress would not cause those companies to become insolvent.

I note that I would consider this to be a severe scenario and that, in practice, market falls of this order of magnitude would take some time to unfold. While they are unfolding, it may be possible for the management of the companies affected to take action to mitigate losses, for example, by changing asset allocations to less volatile asset classes. The Enstar Group companies' investment portfolios are heavily weighted towards bonds. In the event of a financial crisis, such as the credit crisis of 2007, Enstar could be affected by widening credit spreads on its corporate bond holdings, which would reduce the value of the portfolio. This could potentially be mitigated by moving to less risky government bonds. A financial crisis may also result in a fall in equity markets. At times of heightened volatility in equity markets, it may be possible to shift assets out of equities before the full extent of any sustained fall has occurred. To put the stress considered here into perspective, I note that a 20% fall is consistent with the largest ever one-day fall in the S&P 500 index. Scenario tests undertaken by EGL based on historical scenarios show that the most material single event impact to EGL's balance sheet would relate to a credit crisis similar to that experienced in 2007. According to EGL's analysis, such a scenario would reduce the value of its investment portfolio by less than 10% - i.e. considerably less than the stress considered here.

6.129 **Stress 3: failure of external reinsurance.** Mercantile's pro-forma balance sheet comprises four main components: its claims liabilities, its investment assets, its reinsurance asset with Cavello Bay and its external reinsurance asset. Stresses 1 and 2 are concerned with the claims liabilities and investment assets respectively. The reinsurance asset with Cavello Bay is collateralised so it is not exposed to a failure of Cavello Bay, other than in circumstances where the reserves of the Transferring Business deteriorate (the subject of Stress 1), and as the result of a fall in the value of the collateral assets, as discussed in Stress 2. In this stress, I consider a failure of the external reinsurance asset.

Based on figures as at 31 December 2017, the external reinsurance asset of the Transferring Business totalled £111.5 million on an undiscounted basis. I note that this is a relatively smaller part of Mercantile's balance sheet than the other three principal components mentioned above. The largest single external reinsurer (accounting for 38% of the total asset) is Equitas (the vehicle into which were transferred the liabilities of the Lloyd's insurance market in respect of the 1992 and prior underwriting years). Equitas is wholly reinsured (up to a very high limit) by a company in the Berkshire Hathaway Group, which is AA+ rated by Standard and Poor's. The next most significant reinsurer of the Transferring Business, with 14% of the asset, is Aviva plc (which benefits from an A- rating), followed by Swiss Re (7% of the asset), which is AA- rated. Therefore, the three reinsurers that contribute the largest shares together make up about 60% of the reinsurance asset. The nine reinsurers with the next largest shares of the reinsurance asset (all but one of which having a rating between A- and AA) account for a further 25% of the asset.

For simplicity, in this scenario I consider the impact of all third party reinsurance failing. Given the strong credit ratings of most of the external reinsurers, as explained in the preceding paragraph, I regard such a scenario as being extremely remote.

As noted above, as at 31 December 2017, the value of the external reinsurance was estimated to be £111.5 million on an undiscounted basis. The external reinsurance inures to the benefit of Mercantile and Cavello Bay in accordance with the Reinsurance Agreement (i.e. 25% to Mercantile, 75% to Cavello Bay). Therefore, in the event of all of the external reinsurance not performing, recoveries due from Cavello Bay would increase by £83.6 million (i.e. 75% of £111.5 million) and retained reserves would increase by £27.9 million (i.e. 25% of £111.5 million). A loss of £27.9 million to Mercantile could be absorbed by Mercantile's own funds, although its solvency position relative to its SCR would be materially weakened, to the extent that it is likely to only just be able to meet its SCR.

An increase in reserves of £83.6 million could be absorbed by Cavello Bay without significantly diminishing its solvency position. I note that, while Cavello Bay benefits from a considerable amount of external reinsurance in relation to its reinsurance of QBE (see paragraph 4.119 above), any bad debt from those reinsurers is retained by QBE, and Cavello Bay has little other external reinsurance. Therefore, Cavello Bay would not be adversely affected by a material default of reinsurers generally.

The post-Scheme failure of the external reinsurers of the Transferring Business and the resulting reduction in shareholders' funds of Mercantile would not result in a significant impact on EGL's solvency. EEUL has provided me with a schedule showing the exposures within EGL to the twelve largest reinsurers of the Transferring Business (representing over 85% of the reinsurance asset of the Transferring Business). This shows that, based on figures as at 31 December 2017, including those relating to the Transferring Business, EGL held £426 million of reinsurance assets relating to these twelve reinsurers (around \$550m). In the event that these reinsurers defaulted, all other things being equal there would be a reduction in the surplus assets of EGL as at 31 December 2017 of \$3.1 billion (i.e. a reduction of around 18%).

As noted above, the loss of all of the external reinsurance of the Transferring Business is an extremely unlikely scenario, but given that, even in such adverse circumstances, Mercantile would remain solvent and the solvency of Cavello Bay and the wider Enstar Group would also not be threatened by a loss reinsurance from the principal reinsurers of the Transferring Business, the result of this stress test illustrate that there is not a significant dependency on the external reinsurers of the Transferring Business.

6.130 **Stress 4: combination scenario.** In this scenario I consider the effect of a combination of a reserve deterioration, asset price fall and reinsurer failure. For this scenario, I have considered a combination of stresses that are, individually, less extreme (and hence more likely to occur on a standalone basis) than those considered in stresses 1 to 3 above, but which together are very unlikely to occur. I have considered a deterioration in gross reserves of 50% (with a corresponding increase in ceded amounts, prior to bad debt, of 50%), a fall in asset values of 10% and a loss of the value of the external reinsurance asset of 25%.

This scenario would cause the net of external reinsurance reserves of the Transferring Business to increase by £415.4 million (prior to allowing for bad debt). Of this, £103.8 million would be retained by Mercantile. At the same time, Mercantile's investments would fall in value by £40.7 million and it would suffer a loss, resulting from non-performance of the external reinsurance, of £10.5 million (assuming that amounts ceded to external reinsurers also increase by 50%). In total, this would reduce the capital in Mercantile's balance sheet by £155.0 million. This amount is less than the net assets in Mercantile's pro forma balance sheet as at 31 December 2017. Therefore, this combination stress would not cause Mercantile's insolvency, provided that Cavello Bay was able to continue to meet its liabilities under the Reinsurance Agreement. However, Mercantile would fail to meet its solvency capital requirements.

The impact on Cavello Bay would be an increase in its technical provisions on an undiscounted basis of £342.9 million (allowing for the non-performing external reinsurance). On a discounted basis, and converting to US dollars, I estimate this increase to be around \$380 million. This would be combined with a reduction in asset values of around \$230 million. Taking the two together would reduce Cavello Bay's net assets from around \$1.4 billion to \$0.8 billion. As noted under stress 1 above, Cavello Bay, might at the same time, suffer from additional deterioration within its other portfolios, especially those that are in any way correlated with the Transferring Business, although it would appear that Cavello Bay would be able to remain solvent.

EGL would be impacted by the total increase in reserves in the Transferring Business, which I estimate to be around \$500 million on a discounted basis (including the effect of the non-performing external reinsurance). In addition, EGL could lose around \$0.8 billion in value due to the asset stress (as noted above, EGL reported investments of \$7.2 billion in addition to \$1.2 billion of directly managed funds held in its balance sheet as at 31 December 2017). EGL reported total reinsurance balances of around \$2 billion as at 31 December 2018. If it also saw a 25% failure in these assets, it would suffer a loss of \$0.5 billion. In total, it could therefore suffer a loss of around \$1.8 billion. This would represent a significant reduction in its shareholders' funds (\$3.1 billion as at 31 December 2017), but would not leave it insolvent. I note again that any correlations between the various parts of EGL's business would increase the likelihood of similar deteriorations occurring in other parts of its business.

6.131 While it appears that Mercantile will be a more than sufficiently capitalised company, it is heavily dependent on the cover provided under the Reinsurance Agreement with Cavello Bay. From my analysis above, I have satisfied myself that:

- The collateral arrangements should be adequate to meet Cavello Bay's reinsurance obligations in respect of the Transferring Business in the majority of scenarios;
- Cavello Bay is currently a well-capitalised company and, therefore, should be expected to meet its reinsurance obligations in all but extreme circumstances, and should be able to top-up the collateral in respect of the cover for the Transferring Business in all but extreme circumstances;
- In the event of such extreme circumstances that resulted in Cavello Bay being unable to meet its obligations under the Reinsurance Agreement, the guarantee provided by EGL would be triggered. EGL currently has sufficient free assets over and above its capital requirement to be able to meet any shortfall by Cavello Bay against its obligations under the Reinsurance Agreement. While possible, it is unlikely that the other guarantees provided by EGL would have been triggered to such an extent that EGL would be unable to honour its guarantee in respect of the Reinsurance Agreement.

Conclusion

- 6.132 I am therefore satisfied that, although the policyholders of the Transferring Business will be adversely affected by relative differences in the financial strength of Mercantile post-Scheme to those of RSAI and MIC pre-Scheme, the effect on the policyholders will not be material.

IN THE EVENT OF INSOLVENCY

- 6.133 Pre-Scheme, were Cavello Bay to become insolvent, the Transferring Policyholders would continue to have their claims paid by RSAI or by MIC, as appropriate. Furthermore, given the small size of the Transferring Business relative to RSAI's entire portfolio, while a default on its reinsurance contract by Cavello Bay might have a material financial effect on RSAI if combined with EGL also defaulting on its guarantee of the performance of Cavello Bay in respect of the Reinsurance Agreement, it is very unlikely to be one that jeopardised RSAI's solvency and hence its ability to meet its insurance obligations to the RSAI Transferring Policyholders or to meet its reinsurance obligations to MIC. Post-Scheme, were Cavello Bay to become insolvent, then Mercantile, as the post-Scheme insurer of the Transferring Business, would be reliant:

- on the collateral in order to meet Cavello Bay's obligations under the Reinsurance Agreement;
- to the extent that the collateral proves inadequate to meet Cavello Bay's obligations under the Reinsurance Agreement, on the guarantee provided by EGL in respect of the Reinsurance Agreement; and
- to the extent to which collateral and the EGL guarantee proved in aggregate to be inadequate to meet Cavello Bay's obligations under the Reinsurance Agreement, on the available capital within Mercantile

in order to meet its obligations to the Transferring Policyholders. Those Transferring Policyholders would not have any recourse to RSAI or to MIC. This would appear to be a disadvantage of the Scheme from the point of view of the Transferring Policyholders. However, given the level of excess assets within Mercantile, the very low likelihood of Cavello Bay being unable to meet its obligations to Mercantile under the terms of the Reinsurance Agreement and the even lower likelihood that EGL would, in the event of Cavello Bay not meeting its obligations under the terms of the Reinsurance Agreement, be unable to meet its obligations to Mercantile under the terms of the guarantee relating to the Reinsurance Agreement, the insolvency of Mercantile would presently appear to be only a remote possibility.

- 6.134 In the event of RSAI and/or MIC becoming insolvent pre-Scheme, the Transferring Policyholders would be competing with the other direct policyholders of RSAI and MIC, as appropriate, for the remaining assets of the companies. The financial health of MIC is highly dependent on the reinsurance provided by RSAI and, in the event of RSAI's insolvency pre-Scheme, MIC would rank behind the direct policyholders of RSAI (who comprise the vast majority of the RSAI policyholders) for the remaining assets of RSAI. Post-Scheme, in the event of the insolvency of Mercantile, the RSAI Transferring Policyholders and the MIC Transferring Policyholders would rank alongside each other in the distribution of the remaining assets of Mercantile.

CHANGES IN RISK EXPOSURES

- 6.135 If the Scheme is sanctioned, the policyholders of the Transferring Business will no longer be exposed to the risks within RSAI or MIC, but will be exposed to those of Mercantile. While these policyholders are already indirectly exposed, to some extent, to part of the risk exposure of the Enstar Group through Cavello Bay's reinsurance of the RSAI Transferring Business and retrocession of liability relating to the MIC Transferring Business, the Cavello Bay reinsurance asset held in RSAI's balance sheet as at 31 December 2017 represents less than 50% of the surplus of the eligible own funds available to meet the SCR over the SCR itself. Therefore, a failure of this asset would leave RSAI as a more than sufficiently capitalised insurer and would thus be very unlikely to have a significant effect on RSAI's ability to meet the liability payments in respect of the RSAI Transferring Business (including the reinsurance of the MIC Transferring Business). However, the collateralisation of the reinsurance, as well as the guarantee provided by EGL, means that the asset should maintain at least its current value.

- 6.136 There are significant differences between the risk exposures in Mercantile relative to those in RSAI, in particular relating to the types of business written. Post-Scheme, Mercantile will be a relatively small insurer, specialising in the management of run-off business, the liabilities of which include a significant amount of APH exposures. On the other hand:
- RSAI is a large on-going insurer writing large amounts of new business, including UK personal and commercial lines. Within this, RSAI currently has a large and uncertain legacy portfolio, comprising primarily the RSAI Transferring Business and the reinsurance of the MIC Transferring Business, which will be very significantly reduced post-Scheme.
 - MIC is a small on-going insurer, currently writing new business that relates primarily to US renewable energy risks. A large proportion of MIC's gross liabilities comprise an uncertain legacy portfolio (the MIC Transferring Business), which will no longer be part of MIC post-Scheme. However, as MIC's business is wholly reinsured by RSAI, it is exposed to the risk of RSAI defaulting on its reinsurance obligations.
- 6.137 However, different risk profiles, insofar as they might affect the future financial security of policyholders, are reflected in the capital requirements of RSAI, MIC and Mercantile. As I have already concluded, RSAI is currently a well-capitalised company, MIC is currently a very well-capitalised company, and Mercantile will be (post-Scheme) a more than sufficiently capitalised company. Therefore, I conclude that this change in their risk exposure will not have a materially adverse impact on the security of the Transferring Policyholders.
- 6.138 There is also a potential benefit to the Transferring Policyholders in that the Enstar Group specialises in managing legacy businesses, i.e. business similar in nature to the Transferring Business. Thus, it is likely to receive more attention, at least at a senior management level, than it would have done as a relatively small part of a large, diverse, on-going insurance group.

Conclusion

- 6.139 I am satisfied that, although the proposed Scheme will lead to a change to the risk exposures of the Transferring Business, this will not have a materially adverse impact on the security of policyholder benefits.

POLICY SERVICING

- 6.140 There should be little change to the policy administration arrangements of the Transferring Business as a result of the Scheme. Most of the staff within the RSA Group who currently are wholly or largely involved in administering and managing the Transferring Business (these being the Assumed Employees) will transfer to EEUL with effect from the Effective Date and will continue to administer and manage the Transferring Business, with no expected changes in service standards. The Marine and Aviation business within the Transferring Business will be administered and managed by existing staff within EEUL but the service standards will be dictated by the joint RSA Group / Enstar Group Separation and Migration Plan that aims to maintain continuity in both service delivery and service standards pre- and post-Scheme. Between the Effective Date and the Migration Date, the administration and management of the Transferring Business shall be outsourced by Mercantile to RSAI under the Outsourcing Agreement and the Assumed Employees, who will be TUPE transferred to EEUL, will be seconded back to RSAI in order to undertake the services required under the Outsourcing Agreement (in combination with other RSAI staff who are not transferring to EEUL).
- 6.141 I note that there will be no changes to the management arrangements related to the business of the various insurance pools that are part of the Transferring Business. Mercantile will replace MIC as a member of the BAIG and LAIG Pools, both of which are administered by GAUM. Mercantile will replace RSAI as a member of the EIROS pool. I am informed that both GAUM and EIROS have been briefed regarding these changes and are comfortable with them.
- 6.142 The Separation and Migration Plan is complex and is heavily dependent on IT. It will not be fully delivered by the Effective Date, hence the Outsourcing Agreement. If the Migration Date is delayed beyond 1 October 2019 then the Outsourcing Agreement will continue until such time as the Separation and Migration Plan has been completed and fully implemented, thus ensuring the maintenance and delivery of agreed service standards.

- 6.143 I have reviewed the Separation and Migration Plan at a high level and consider it reasonable. That plan is now being implemented, overseen by the joint RSAI and Enstar Separation and Migration Steering Committee. I have been informed that the separation and migration process is expected to be completed by the end of the third quarter 2019. However, I recognise that there remain many challenges facing the Separation and Migration teams in delivering this plan both on time and fully functioning. I will continue to monitor progress against the plan and will reflect on that progress in the Supplementary Report.
- 6.144 I have also reviewed the Term Sheet of the Outsourcing Agreement. As at the date of this Report, the Outsourcing Agreement has not been signed by RSAI and Mercantile, but they had both agreed the content of the Term Sheet. In paragraph 5.32 above I have outlined some of the terms contained in the Term Sheet. Based on my review, it appears that, while the Outsourcing Agreement is operational, all aspects of the policy servicing will continue as they had done prior to the Effective Date, including the day-to-day management by RSAI of the Assumed Employees who have been seconded back to RSAI from EEUL, which will facilitate continuity and maintenance of service standards.
- 6.145 I therefore have no reason to believe that there will be any change to policy servicing resulting from the Scheme.

Conclusion

- 6.146 I believe that the proposed Scheme is unlikely to have a materially adverse impact on the standards of policy servicing experienced by the RSAI Transferring Policyholders and the MIC Transferring Policyholders compared to their current position.

BREXIT

- 6.147 As noted in paragraph 3.24 above, the process by which the UK exits the EU has begun and, unless otherwise agreed by the UK and all of the remaining EU member states, will have concluded on or before 29 March 2019.
- 6.148 The terms of Brexit are subject to negotiation and it is unlikely that those terms will be known publicly until shortly before the exit date. Therefore, it is difficult to anticipate the effects of Brexit without resorting to speculation. However, in the context of the Scheme, there are some themes that should be considered. In particular, I need to consider whether Brexit will reinforce or mitigate the effects of the Scheme on the Transferring Policyholders.
- 6.149 As the Transferring Business is all in run-off, there would be no issues created by Brexit regarding cross-border selling. I am unaware of any reason why the enforceability of any existing contract within or that relates to the Transferring Business would be affected by Brexit.
- 6.150 Post Brexit, RSAI, MIC and Mercantile would continue to be regulated by the PRA and FCA; and Cavello Bay would continue to be regulated by the BMA.
- 6.151 As noted in paragraph 4.54 above, in order to enable it to deliver its strategic plan post-Brexit, RSAI has established a new subsidiary (RSAL), into which the non-UK EU business has been transferred, via a Part VII transfer, with effect from 1 January 2019. I understand that no part of the Transferring Business overlapped with the business transferred to RSAL.
- 6.152 The Effective Date of the Scheme is after the Brexit date (29 March 2019). It remains possible that it will be a “hard” Brexit, i.e. that few if any of the trading benefits that UK entities enjoy through the UK’s membership of the EU will continue post-Brexit, without any implementation/transition period. Were that to happen then many UK insurers would no longer be authorised to administer or otherwise service their policies that were written under passporting arrangements in certain non-UK EEA states. As noted in paragraph 4.115 above, that could affect a very small number (currently believed to be five) of non-UK EEA policyholders within the MIC Transferring Business. The short gap between Brexit and the Effective Date would cause only a short interruption in the ability of MIC to service its business in those EEA states that require the establishment of a locally authorised branch to ensure the continued payment of claims under contracts in run-off by a third country insurer/reinsurer. This might not be an issue at all if interim measures are put in place, to soften the immediate impact of Brexit, depending on what those interim measures are.

- 6.153 After the Effective Date, the MIC Transferring Business will be within Mercantile. Were it to be a hard Brexit then Mercantile, like MIC, would not be authorised to administer or otherwise service the policies of the five policyholders in those three EEA states that require the establishment of a locally authorised branch to ensure the continued payment of claims under contracts in run-off by a third country insurer/reinsurer. As discussed in paragraph 4.115 above, in those circumstances, the Enstar Group considers it disproportionate for Mercantile to establish a branch in each of the three EEA states. Instead, if passporting rights are lost as a result of Brexit, it intends that Mercantile liaises with the regulators in those states. If it becomes apparent that Mercantile will be required to take steps to satisfy the relevant local requirements, then it will proceed to do so, while also seeking to settle, commute or novate to a suitably authorised entity the policies.
- 6.154 Any Brexit-related interruptions to the levels of service currently enjoyed by non-UK EEA policyholders within the MIC Transferring Business will be the same whether or not the Scheme goes ahead.

Effect on balance sheets

- 6.155 Immediately following the referendum, the value of Sterling on the currency exchange market dropped sharply and continued to fall throughout the summer. This was largely balanced by rises in the UK equity market, partially fuelled by higher expected levels of exports due to the weaker value of Sterling.
- 6.156 It is unclear what will happen to Sterling and to UK asset values over the period of the Brexit negotiation and following Brexit itself. However, it is likely that there will be instability, especially as rumours and speculation emerge regarding the progress of those negotiations. Any such instability would affect the balance sheets of companies with assets and/or liabilities in multiple currencies including Sterling, although the impact could be mitigated by the matching of assets and liabilities by currency.

Conclusion

- 6.157 I do not believe that Brexit will materially alter the expected effects (if any) of the proposed Scheme on the security of the benefits or the standards of policy servicing experienced by the Transferring Policyholders.

CONCLUSION FOR THE POLICYHOLDERS OF RSAI AND MIC TRANSFERRING UNDER THE SCHEME

- 6.158 I am satisfied that the proposed Scheme does not affect in a materially adverse way either the security or the policy servicing levels of the Transferring Policyholders.

7. THE IMPACT OF THE SCHEME ON THE POLICYHOLDERS OF THE TRANSFERORS WHO WILL NOT TRANSFER UNDER THE SCHEME

- 7.1 In this Section of the Report, I consider the impact of the Scheme on those policyholders whose policies will not be transferred to Mercantile but which will remain within either of the Transferors after the Effective Date.
- 7.2 Within RSAI this will be a large proportion of the policyholders. Within MIC it will be a smaller but still significant proportion of the policyholders.
- 7.3 However, as noted in paragraphs 5.23-5.26 above, it might not be possible legally to transfer all policies within the Transferring Business and any policies that cannot be transferred would be deemed Non-Transferred Policies. When discussing the impact of the Scheme on the policyholders of RSAI and MIC who will not transfer under the Scheme, I am including those Transferring Policyholders who hold Non-Transferred Policies.

RSAI

- 7.4 As the RSAI Transferring Business is currently a relatively small part of RSAI's portfolio, and is already 100% reinsured into Cavello Bay, the non-transferring policyholders will be, to all intents and purposes, unaffected by the Scheme.
- 7.5 I have already illustrated, in Table 5.1 above, that RSAI's pre- and post-Scheme balance sheet would be largely unchanged, save for the removal post-Scheme of the amounts labelled as "assets held for sale" and "liabilities held for sale". As explained in paragraph 6.7 above, on an undiscounted basis, the gross provisions relating to the RSAI Transferring Business and the 100% reinsurance of the MIC Transferring Business are roughly 12% of the total gross provisions of RSAI.
- 7.6 The only component of the SCR that would be noticeably impacted by the Scheme would be reinsurance credit risk, which would reduce slightly as a result of the Scheme, thus reducing the SCR. The Scheme would therefore increase by a small amount RSAI's eligible own funds, due to reductions in the risk margin. Hence, the effect of the Scheme would be to increase slightly the Capital Cover Ratio (although RSAI would remain a well-capitalised company) and hence increase slightly the financial security enjoyed by the remaining RSAI policyholders.
- 7.7 Currently, if Cavello Bay were to fail and were EGL not to honour its obligations under its guarantee, the gross liabilities of the RSAI Transferring Business would fall back on RSAI. Given the size of the RSAI Transferring Business and the current level of surplus capital within RSAI, this is unlikely to affect materially the other policyholders of RSAI. If the Scheme were sanctioned then this risk would be removed, and in this way the remaining RSAI policyholders would benefit from the Scheme. Similarly, were RSAI to be wound-up (a possibility that also appears to be remote, based on RSAI's current excess assets, as described in Section 6 above), those remaining RSAI policyholders would be marginally better off had the Scheme been sanctioned, as post-Scheme there would be fewer policies with which to share the remaining assets of RSAI.
- 7.8 As noted above in paragraph 5.23, it is possible that, after the Effective Date, there might remain in RSAI some RSAI Non-Transferred Policies. The gross liability for these will remain with RSAI but they will be 100% reinsured by Mercantile (which in turn would be 75% reinsured by Cavello Bay). In this respect, the situation of the holders of the RSAI Non-Transferred Policies would be very similar to that prior to the Effective Date. There would also be no changes to the policy servicing or administration of the RSAI Non-Transferred Policies.
- 7.9 While Brexit might affect the non-transferring policyholders of RSAI (see paragraph 4.54 above), I do not believe that it would exacerbate, to any material degree, the impact on them of the Scheme.

Conclusion for the policyholders of RSAI not transferring under the Scheme

- 7.10 I am satisfied that the non-transferring policyholders of RSAI would not be adversely affected by the Scheme.

MIC

- 7.11 The MIC Transferring Business is currently a material part of MIC's portfolio. However, as it, along with the rest of MIC's business, is already 100% reinsured into RSAI, the non-transferring policyholders will be, to all intents and purposes, unaffected by the Scheme.
- 7.12 The Scheme should have no impact on MIC's eligible own funds. The only component of the SCR that would be noticeably impacted would be reinsurance credit risk, which would reduce significantly as a result of the Scheme. Therefore, the effect of the Scheme would be to reduce the SCR and thus to increase the Capital Cover Ratio (although MIC would remain a very well-capitalised company) and hence increase slightly the financial security enjoyed by the remaining MIC policyholders. However, in reality, the non-transferring policyholders of MIC will continue to be largely dependent for their financial security upon RSAI.
- 7.13 Currently, if RSAI were to fail, so that it was unable to meet fully its obligations under the reinsurance arrangements, then the MIC policyholders would be dependent on the current capital within MIC to meet any shortfall. This would need to be shared between policyholders of the MIC Transferring Business and those that remained within MIC. Were the Scheme sanctioned, the remaining policyholders would no longer, in the event of RSAI's failure, have to share MIC's capital with the policyholders of the MIC Transferring Business, and in this way the remaining MIC policyholders would benefit from the Scheme. Similarly, were MIC to be wound-up (a possibility that also appears to be remote, based on MIC's current excess assets, as described in Section 6 above), those remaining MIC policyholders would be marginally better off had the Scheme been sanctioned, as there would be fewer policies post-Scheme with which to share the remaining assets of MIC.
- 7.14 As noted above in paragraph 5.23, it is possible that, after the Effective Date, there might remain in MIC some MIC Non-Transferred Policies. The gross liability for these will remain with MIC but they will be 100% reinsured by Mercantile (and then 75% retroceded to Cavello Bay). In this respect the situation of the holders of the MIC Non-Transferred Policies would be similar to that prior to the Effective Date, save that they would be reinsured by Mercantile, rather than by RSAI, and that only 75% of the liabilities covered under that reinsurance arrangement would then be retroceded to Cavello Bay. There would also be no changes to the policy servicing or administration of the MIC Non-Transferred Policies.

Conclusion for the policyholders of MIC not transferring under the scheme

- 7.15 I am satisfied that the non-transferring policyholders of MIC would not be adversely affected by the Scheme.

8. OTHER CONSIDERATIONS

ASSETS AND LIABILITIES OF RSAI, MIC AND MERCANTILE

- 8.1 Since the Transferring Business is currently entirely reinsured by Cavello Bay, the only transferring assets are expected to be the benefit of those reinsurance contracts (or, in respect of any reinsurance contract that covers both policies within the Transferring Business and policies that will remain with the Transferor(s) post the Effective Date, such rights and obligations under that contract that relate to the Transferring Business) and other third party contracts, reinsurance recoveries, salvage and subrogation rights and the books and records, all as pertaining only to the Transferring Business.
- 8.2 The Court has the power to order (and the Scheme provides for) the transfer to Mercantile of the relevant outwards reinsurance contracts in respect of the Transferring Business. On the basis that RSAI's outwards reinsurance contracts relating solely to the RSAI Transferring Business and that MIC's outwards reinsurance contracts relating solely to the MIC Transferring Business are transferred as part of the Scheme, the net (of reinsurance) position of Mercantile prior to application of the Reinsurance Agreement should not be adversely impacted as a result of the Scheme, and thus the gross position of Cavello Bay should also not be adversely impacted as a result of the Scheme.

OPERATIONAL PLANS AND CHANGES IN ASSETS AND LIABILITIES UP TO THE EFFECTIVE DATE

- 8.3 In this Report, I have shown balance sheet data for RSAI, MIC, Mercantile and Cavello Bay as at 31 December 2017 (this being the most recent date for which audited financial information is available). I have also shown pro forma balance sheets, which have been based on those actual balance sheets as at 31 December 2017, but which include data, as at 31 December 2017, that relates to subsequent transactions, such as the Scheme.
- 8.4 I expect that the current activities of RSAI and MIC have continued, and will continue, between 31 December 2017 and the Effective Date (and, as appropriate, after the Effective Date). RSAI and MIC have continued, and will continue, to write new business, and have continued, and will continue, to settle claims and reassess reserves in the light of experience. I do not consider that any material additional risk to any group of affected policyholders will emerge as a result of the continuation of normal business.
- 8.5 The Enstar Group continues to consider other portfolios of run-off business to acquire and may use Mercantile as a vehicle for taking on such portfolios if it is deemed appropriate. I have been told that no specific acquisitions are currently planned that involve Mercantile or, other than as discussed in paragraph 4.131 above, Cavello Bay. Any such transaction would be subject to proper review and regulatory scrutiny prior to approval, to ensure that the interests of the existing policyholders of Mercantile (which initially would include the Transferring Policyholders, assuming that the Court approves of the Scheme) would not be adversely affected to a material degree by the transaction.
- 8.6 I believe that it is unlikely that any events occurring between 31 December 2017 and the Effective Date would affect any conclusion that I have reached based on my review as at 31 December 2017. While I note that there is potential for delays to occur in the implementation of the Separation and Migration Plan such that it is not completed as expected by the end of the third quarter of 2019, I consider that, based on my review of the Term Sheet, the operation of the Outsourcing Agreement will ensure that such delays will not adversely impact upon the policy servicing currently enjoyed by the Transferring Policyholders.
- 8.7 A short time before the final Court hearing, I will consider the extent to which actual changes in assets and liabilities have been in line with expectations (relative to the position as at 31 December 2017) and hence whether there have been any changes (including those associated with current economic conditions) that would affect my overall opinion, and, if necessary, I will report on these separately in the Supplementary Report.

MIS-SELLING LIABILITIES

8.8 In her judgement regarding the recent case of PA(GI) Limited v (1) GICL 2013 Limited (2) Cigna Insurance Services (Europe) Limited (2015), Mrs Justice Andrews DBE said that “...an intention to make provision for the transfer of mis-selling liabilities would qualify as an unusual feature which might have a material financial impact on the scheme, and which one would therefore expect to be expressly disclosed in the context of an application for a transfer under a Part VII scheme.” Neither RSAI nor MIC is aware of any actual or potential mis-selling liabilities within their respective businesses. The Transferring Business comprises only commercial insurance business and no personal lines direct business. While it is possible for commercial insurance to be mis-sold, it is in general considered less likely to occur than in respect of personal lines policies, especially on a systemic basis. Moreover, the Transferring Business was written at least 10 years ago and on an intermediated basis. Therefore, I think that the likelihood of any mis-selling liabilities emerging in relation to the Transferring Business is very small and it would be reasonable to assume the expected cost of such liabilities to be at most negligible. In any event, it is intended that the Scheme will transfer any such liabilities, should they arise in relation to the Transferring Business, from RSAI and MIC to Mercantile. Any mis-selling liability that arises within RSAI or MIC that is not related to the Transferring Business would not be transferred from RSAI or MIC to Mercantile as part of the Scheme. I have not considered it necessary to comment further on this matter in this Report.

LIKELY IMPACT ON STAFF PENSION RIGHTS AND LIABILITIES

8.9 I understand that the defined benefit pension schemes that related to RSAI employees have been closed for some time both to new members and to further accruals. Therefore, any defined benefit pension arrangements that apply to the Assumed Employees have been deferred. Therefore, the Scheme is expected to have negligible impact upon the remaining pension liabilities within RSAI.

THE LIKELY EFFECTS OF THE SCHEME UPON REINSURERS OF THE TRANSFERRING BUSINESS

- 8.10 In accordance with the PRA Statement of Policy and SUP18, I have considered the likely effects of the Scheme on the reinsurers whose reinsurance contracts cover the Transferring Business.
- 8.11 Leaving aside the 100% reinsurance of the MIC Transferring Business by RSAI, the relevant shares of all reinsurance contracts benefiting the Transferring Business will transfer under the Scheme. As at 31 December 2017, the reinsurers' share of outstanding claims and IBNR claims amounted to approximately³⁹
- £87.4 million in respect of the RSAI Transferring Business on an undiscounted basis; and
 - £24.1 million in respect of the MIC Transferring Business on an undiscounted basis.
- 8.12 The amount of the liabilities of each external reinsurer of the Transferring Business will not change as a result of the Scheme.
- 8.13 As noted in paragraph 1.16 above, the administration of the Transferring Business is currently largely performed on behalf of RSAI and MIC by the Assumed Employees and will continue to be so post the Effective Date of the Scheme, the Assumed Employees then having been transferred to EEUL. I have no reason to expect any change in the standards of claims handling or management. Therefore, the magnitude and timing of recoveries claimed against reinsurance contracts relating to the Transferring Business will be unaffected by the Scheme.

39 These numbers are based on the final 2017 year-end numbers for RSAI and MIC and as such, and as noted elsewhere in this Report, differ slightly from those in the Business Plan for Mercantile.

8.14 I have considered whether the Scheme is likely to lead to any changes in the rights of “set-off”⁴⁰ for creditors or debtors of RSAI or MIC (Mercantile currently has no remaining insurance liabilities and so this issue is not relevant to Mercantile). The Transferring Business comprises inwards insurance contracts mitigated by outwards reinsurance contracts. Any mutual debits or mutual credits relating solely to the Transferring Business would be available, post-Scheme, to Mercantile but any that existed in either RSAI or MIC where one side only related to the Transferring Business would be lost. I have been told that the amount of set-off within either RSAI or MIC that would be lost as a result of the Scheme is small. This would only be an issue were RSAI or MIC, post-Scheme, to become insolvent. As explained above, I consider the likelihood of either RSAI or MIC becoming insolvent, post-Scheme, to be remote (particularly in the short-term). As such I do not believe the right of set-off affects my conclusions on the impact of the Scheme on reinsurers.

Conclusion for the reinsurers of the Transferors whose contracts of reinsurance are to be transferred by the Scheme

8.15 For the reasons discussed above, I am satisfied that the Scheme will not have a materially adverse effect on the reinsurers of RSAI and MIC whose contracts of reinsurance are to be transferred by the Scheme.

THE APPROACH TO COMMUNICATION WITH POLICYHOLDERS

8.16 Regulations made under the FSMA require a communication regarding the proposed Scheme to be sent to every policyholder of the Companies. However, consideration may be given to the practicality and costs of sending notices against the likely benefits for policyholders of receiving such communications. In order to comply with both paragraph 2.53 of the Policy Statement and paragraph 2.46G of SUP18, the Companies would be expected to notify the policyholders, or interested persons, at least six weeks before the date of the Court hearing at which the application to sanction the Scheme will be heard.

8.17 The Companies’ approach to communicating the Scheme to affected policyholders is outlined in paragraphs 5.53-5.61 above.

8.18 I consider the approach being taken to those Transferring Policyholders and reinsurers that RSAI intends contacting directly, as well to those claimants and Transferring Policyholders that RSAI intends contacting indirectly, to be reasonable. I also consider it reasonable that Mercantile makes no direct notifications as it has no existing policyholders.

8.19 I have reviewed draft copies of the proposed notices and letters, including the draft summary of the Scheme and of the Report. I am not an expert in such communications. However, I consider the draft notices and letters to be clear and concise, to contain all of the information that I would expect them to contain, to be fair, and to be appropriate for their intended audiences.

8.20 I have also considered, in broad terms, the waivers that RSAI and MIC seek that would absolve it of responsibility for notifying directly various groups of policyholders who might otherwise be affected, as set out in paragraph 5.56 above.

- I consider it reasonable for RSAI and MIC to seek to notify claimants via the lawyers or policyholders through whom the claims have been brought.
- I consider it reasonable for RSAI and MIC not to notify directly those RSAI Transferring Policyholders and MIC policyholders for which it does not have contact details and is unable to obtain such details, and instead to notify them indirectly via intermediaries or via publicity (advertisements, published notices, etc.).

40 “Set-off” allows parties to cancel or offset mutual debts with each other by subtracting one from the other, and paying only the balance.

- I consider it reasonable that the policyholders of RSAI policies that are not included within the Transferring Business need not be notified directly. The RSAI Transferring Business is very different in nature to the vast majority of the business remaining in RSAI. As I discuss in Section 7 above, the impact of the Scheme on the remaining policyholders is expected to be slight and their relationship with RSAI will not be affected by the Scheme. Moreover, the cost of direct notification of such policyholders would be disproportionately large (it has been estimated to be in excess of £14 million).

8.21 I am satisfied that the proposed approach to communication with policyholders in respect of the Scheme is both proportionate and reasonable.

WHAT WOULD HAPPEN WERE THE SCHEME NOT TO PROCEED?

8.22 In accordance with the BTA, if the Scheme has not been effected by 1 July 2019 then the parties will negotiate to seek an alternative manner in which to transfer the business or, if no alternative arrangement is agreed, the BTA will terminate and the business will not be transferred. The Reinsurance Agreement will remain in effect unless notice is served by RSAI.

8.23 In the event that the Scheme does not proceed (and no alternative is agreed to by the parties), it would appear that the status quo would be maintained. The policyholders of the Transferring Business would continue to be policyholders of RSAI and MIC and would have their claims serviced by the RSA Group, and RSAI would continue to benefit from the reinsurance protection purchased from Cavello Bay. I have concluded above that the Transferring Policyholders currently benefit from the financial strength afforded by well-capitalised or very well-capitalised companies and would continue to do so if the Scheme were not to proceed.

8.24 The non-transferring policyholders of RSAI and MIC would be in the same position as they are currently. Mercantile would have no policyholders.

8.25 I do not believe that any group of policyholders would be adversely affected if the Scheme were not to proceed.

LEGAL JURISDICTION

8.26 I understand an insurance business transfer scheme as defined in Section 105 of FSMA would be effective as a result of the Court Order sanctioning the business transfers for all policies governed by the law of an EEA member state. However, there is no obligation on the courts of non-EEA states to recognise automatically the ability of the Court to transfer a policy governed by non-EEA state laws. Thus, it may be possible for one or more transferring policyholders with non-EEA policies to challenge the validity of the sanctions transfer subsequent to its effective date.

8.27 I have been told that none of the RSAI Transferring Business relates to insurance contracts governed by laws other than those of EEA member states. However, I understand that, of the reserves relating to the MIC Transferring Business, the following percentages are in respect of policies governed by particular laws:

- UK law: 10%
- US law: 81%
- Law of non-UK EEA states: 4%
- Law of non-US, non-EEA states: 5%.

8.28 As 86% of the MIC Transferring Business relates to policies governed by non-EEA law, there is a risk that one or more transferring policyholders with non-EEA policies will challenge the validity of the Scheme, subsequent to the Effective Date.

- 8.29 I note that some legal jurisdictions operate the principle of comity (i.e. legal reciprocity), although I understand that the circumstances in which they would recognise the rulings of another nation's courts vary from country to country. I have seen a legal opinion, obtained by RSAIG and MIC, that, were such a claim to be brought before a US court, there are good grounds to expect that a US court would consider it appropriate to apply the principle of comity and thus recognise the order of the Court. I am not a legal expert and cannot comment on the detail of the advice provided but, based on the arguments put forward, the conclusions and the opinion appear to me to be reasonable. Because the legal advice has been provided by a reputable firm with suitable experience, because the advice provided appears to me to be well presented and has not raised any questions or concerns, and because it is consistent with my understanding of similar advice offered in respect of previous Part VII transfers, I have decided that there is no need for me to seek further legal advice on the matter from lawyers otherwise unconnected with the proposed Scheme.
- 8.30 I note that similar advice has not been sought in respect of other non-EEA states under whose laws MIC Transferring Business has been written. In view of the comparatively small amount of such business, relative to the Transferring Business as a whole, and taking into account the principle of comity (while accepting that it would not apply in all countries), I consider it reasonable that MIC has not sought such advice.
- 8.31 The Court Order sanctioning the business transfers would also apply to all reinsurance contracts included within the Transferring Assets that were governed by the law of an EEA member state. However, as with the inwards business, there is no obligation on the courts of non-EEA states to recognise automatically the ability of the Court to transfer a reinsurance contract governed by non-EEA state laws. Of the ceded reserves relating to the Transferring Business, the following percentages are in respect of reinsurance contracts (covering RSAI Transferring Business and MIC Transferring Business) governed by particular laws:
- UK law: 84%
 - US law: 13%
 - Law of non-UK EEA states: 1%
 - Law of non-US, non-EEA states: 2%.
- 8.32 I would expect the same legal principles to apply in respect of the recognition of the transfer of outwards reinsurance contracts as applied in respect of the transfer of inwards business.
- 8.33 Under the terms of the BTA, Mercantile shall, from the Effective Date, indemnify the Transferors against any and all losses suffered or incurred by the Transferors as a result of any failure by Mercantile to discharge the liabilities that it has assumed through the Scheme.

TAX

- 8.34 I have seen correspondence between tax advisors to RSAI and HM Revenue and Customs ("HMRC") that discusses the tax treatment of the Scheme. The tax advisors argued that the initial reinsurance transaction between RSAI and Cavello Bay (initially Fitzwilliam) be treated as a VAT exempt reinsurance supply. They further argued that the subsequent transfer of Transferring Business from RSAI and MIC to Mercantile should be treated as a "Transfer of a business as Going Concern ("TOGC") and, as such, would also not be subject to UK VAT. HMRC confirmed that it was satisfied by the tax advisors' arguments and conclusions.
- 8.35 I have been further informed by Enstar and by RSAI that the Scheme is not expected to have other tax implications that would affect any of the Companies or any of the groups of policyholders identified in paragraph 5.20 above, save that Mercantile would be subject to Corporation Tax on any profit emerging from the run-off of the Transferring Business. This is consistent with what I have seen in respect of other, similar transfers between UK entities.

COSTS OF THE SCHEME

- 8.36 The external costs of the Scheme have been estimated by RSAI and Enstar to be between £3.2 million and £3.4 million, based on the Scheme and planned communication with policyholders as outlined above, i.e. assuming that RSAI and MIC are successful in their application to the Court for waivers as explained in paragraph 5.56 above). These costs will be met by RSAI and MIC on the one hand and Mercantile on the other hand in accordance with the BTA. While not immaterial, the costs will not have a significant effect on the overall surplus capital of either RSAI/MIC or Mercantile.

9. CONCLUSIONS

9.1 In summary, in my opinion, provided the proposed Scheme operates as intended, and I have no grounds for believing that it will not do so:

- The security of benefits to policyholders of RSAI and MIC, both those being transferred under the Scheme and those not transferring, will not be materially adversely affected by the implementation of the Scheme on the Effective Date; and
- The Scheme will have no impact on service standards (operated in accordance with TCF criteria) experienced by the policyholders of RSAI and MIC, both those being transferred under the Scheme and those not transferring.

9.2 In reaching this opinion I have applied the following principles:

- I have considered which parties might be affected by the Scheme and in what way. I have documented my findings.
- I have not performed my own modelling, rather I have relied on the results of models developed and operated within RSAI, MIC, Mercantile and Cavello Bay. I have reviewed documentation describing the models, describing and justifying the assumptions underlying those models, and explaining the derivation of the data underlying the models and assumptions, in particular explaining how its accuracy, completeness and relevance has been verified.
- To the best of my knowledge there are no beneficiaries for whom the impact of the Scheme has not been considered.
- I have considered how the Scheme might lead to any changes in the material risks to the benefits of the different interested parties.
- I have considered the impact on the actuarial information provided to me of RSAI, MIC, Mercantile and Cavello Bay having adopted alternative plausible assumptions.



Derek Newton / 16 January 2019

Fellow of the Institute and Faculty of Actuaries

APPENDIX A DEFINITIONS

Actuarial Indications	Reserve assessments, performed on a best estimate basis by RSAI actuaries.
ADC	Adverse Development Cover, which is a type of reinsurance cover that applies to a portfolio of business and limits the deterioration of claim costs on an aggregate basis for that portfolio beyond a pre-agreed point.
APH	Asbestos, pollution and health hazards.
Assumed Employees	Those RSAI employees who are wholly or mainly engaged in relation to the Transferring Business and who will be transferred to the Enstar Group entity that post-Scheme will be assuming the claims handling and management of the Transferring Business at the same time as the Scheme becomes effective.
Available Capital	Capital available to meet solvency capital requirements.
AWP	Asbestos Working Party – this working party was formed by members of the IFoA to investigate asbestos related claims based on UK market data, to investigate trends and to react accordingly. It has been established for roughly 15 years and has produced papers in 2004, 2008 and 2009. The 2004 and 2009 papers included models of the estimated UK market costs. At the time of drafting this Report, the AWP was expected to publish a new report, including a new model, imminently.
BAIC	British Aviation Insurance Company Limited, 57% of which is owned by RSA Group.
Belmont	Belmont Run-off Limited, a member of the Enstar Group.
Best estimate	This term is used in this Report in reference to outstanding claim reserves and is intended to represent an expected value over a reasonable range of estimates. As such they are not deliberately biased upwards or downwards, and do not include any margins. However, the limitations of actuarial projection methods mean that “best estimates” are not statistically rigorous estimates of the mean of the underlying distributions of all possible outcomes.
BMA	Bermuda Monetary Authority, which acts as Bermuda's financial system regulator.
Brexit	“Brexit” is an abbreviation of “British Exit”, which refers to the impending exit of the UK from the European Union, following the referendum on continuing membership held in the UK in June 2016. As at the time of drafting this Report, the terms of Brexit were unknown.
Brittany	Brittany Insurance Company Limited, a Bermuda domiciled exempted insurance company that the Enstar Group acquired in 2001.
BSCR	Bermuda Solvency Capital Requirement, which is a standard risk-based capital adequacy model required of all insurers regulated by the BMA.
BTA	The Business Transfer Agreement, signed on 7 February 2017, between RSAI, MIC and Mercantile.
Business Plan	The 2017 Regulatory Business Plan for Mercantile.
Capital Cover Ratio	The ratio of Available Capital to Required Capital. This is a measure of the capital strength of the insurer – the higher the ratio, the stronger the company.
Cavello Bay	Cavello Bay Reinsurance Limited, a member of the Enstar Group.
CCR	Coca-Cola Refreshments USA Inc.
CD Ratio	Claimant-to-death ratio - the proportion of mesothelioma deaths by year that will result in an insurance claim.
CISSA	Commercial Insurance Solvency Self-Assessment, which is a regime operated by the BMA that requires commercial insurers to perform an assessment of their own risk and solvency requirements. The CISSA provides the BMA with the insurer's perspective of the capital resources necessary to achieve its business strategies and remain solvent given its risk profile, as well as insight into the risk management and governance procedures surrounding this process.

CLO	Collateralised loan obligation, which is a security backed by a pool of debt, often low-rated corporate loans.
The Companies	The collective term for RSAI, MIC and Mercantile.
Correlation	Correlation (in the context of this Report) is a number that describes the statistical relationship between two variables (e.g. equity prices and interest rates).
The Court	The High Court of Justice of England and Wales.
DMI	Domestic Mortgage Indemnity, a form of insurance that protects lenders against the value of the underlying property having fallen below the value of the loan in the event of repossession and resale of the property.
ECR	Enhanced Capital Requirement (“ECR”) is a measure of solvency capital that is used by the BMA in respect of insurers domiciled in Bermuda. For an insurer it is equal to the highest of three measures of capital requirements: the minimum solvency margin applicable to the insurer’s class; the BSCR applicable to the insurer; and the solvency capital requirement calculated using the insurer’s internal capital model, as approved by the BMA.
EEA	The European Economic Area (“EEA”) was established by the EEA Agreement on 1 January 1994. The EEA unites the 28 EU member states with Iceland, Liechtenstein, and Norway into an internal market governed by the same basic rules. These rules aim to enable goods, services, capital, and persons to move freely about the EEA in an open and competitive environment, a concept referred to as the four freedoms.
EEUL	Enstar (EU) Limited, a member of the Enstar Group.
Effective Date	The date on which the Scheme shall become operative.
EIOPA	The European Insurance and Occupational Pensions Authority (“EIOPA”) was established in consequence of the reforms to the structure of supervision of the financial sector in the European Union, with the goals of: better protecting consumers and rebuilding trust in the financial system; ensuring a high, effective and consistent level of regulation and supervision taking account of the varying interests of all Member States and the different nature of financial institutions; greater harmonisation and coherent application of rules for financial institutions & markets across the European Union; strengthening oversight of cross-border groups; and promoting coordinated European Union supervisory responses.
EIROS	Electricity Supply Industry Run-Off Services Limited, which has been fully in run-off since 1982.
EL	Employers’ Liability, a form of commercial insurance that enables employers to meet the cost of compensation to any of their employees who suffer injury or illness through their work.
ELTO	Employers’ Liability Tracing Office, which is an independent, not-for-profit UK company limited by guarantee and funded by a levy, and which aims to help claimants suffering from a disease/injury caused at work to find the insurer of their former employer.
Enhanced	Enhanced Reinsurance Limited, a Bermuda-based company that will reinsure life, non-life run-off and property and casualty insurance business, sourced initially from Allianz SE and the Enstar Group
ENID	In estimating the technical provisions under Solvency II, insurers must make allowance for events not in data (“ENID”), i.e. those possible future events or developments that have not been seen in the historic claims experience of the insurer.
EGL	Enstar Group Limited, the ultimate parent company in the Enstar Group.
EIM	The Enstar Investment Management team, a member of the Enstar Group.
The Enstar Group	A collective term for EGL and its direct and indirect subsidiaries.
Exco	This is an executive committee set up by the UK non-life run-off companies within the Enstar Group, to provide a focal point for the system of governance of those companies and for interaction with EGL and with EEUL.

FCA	The Financial Conduct Authority (“FCA”) is the UK regulatory agency that focuses on the regulation of conduct by retail and wholesale financial services firms. The FCA operates as part of the regulatory framework implemented under the Financial Services Act 2012.
Fitzwilliam	Fitzwilliam Insurance Limited, a member of the Enstar Group, acting in respect of its segregated account number 38.
FSA	The Financial Services Authority was the UK regulator for financial services until 2012. Its responsibilities were then taken over by and divided between the PRA and the FCA.
FOS	Set up by the UK Parliament, the Financial Ombudsman Service (“FOS”) is the UK’s official expert in sorting out problems with financial services.
FSCS	The Financial Services Compensation Scheme (“FSCS”) is the compensation fund of last resort for customers of UK authorised financial services firms.
FSMA	Financial Services and Markets Act 2000, the legislation under which Part VII governs the transfer of (re)insurance business between (re)insurance undertakings.
FSMA Report	A report on the terms of a transfer under Part VII of FSMA, to be prepared by an independent person. The FSMA Report is required in order that the Court may properly assess the impact of the proposed transfer, including the effect on the policyholders of the insurance companies in question.
GAAP	Generally accepted accounting principles (“GAAP”) form the standard framework of guidelines for financial accounting used in any given jurisdiction.
GAUM	Global Aerospace Underwriting Management Limited.
GBP	GB Pounds, or Sterling.
GMT	Greenwich Mean Time.
GSSA	Group Solvency Self-Assessment.
GVC	Group Volatility Cover, a type of reinsurance cover designed to protect against aggregate losses across a group of insurers.
HMRC	Her Majesty’s Revenue and Customs, the non-ministerial department of the UK Government that is responsible for the collection of taxes.
HSE	The Health and Safety Executive is the non-departmental public body responsible for the encouragement, regulation and enforcement of workplace health, safety and welfare, and for research into occupational risks in the UK (although the HSE entity operating in Northern Ireland is separate from that operating in Great Britain).
IBNR reserves	These are reserves in respect of claims that relate to claim events that have occurred before the valuation date but that were still to be reported to the insurer as at that date. For the purposes of this Report they also include reserves in respect of any perceived shortfall between the projected ultimate costs and the case estimates for claims already notified.
IFoA	The Institute and Faculty of Actuaries, the professional body for actuaries in the UK.
Independent Expert	The Independent Expert prepares the FSMA Report and provides it to the Court in order that it may properly assess the impact of the proposed transfer, including the effect on the policyholders of the insurance companies in question. In the case of the Scheme, I have been appointed as the Independent Expert.
Independent Peer Review	Work Review undertaken by one or more individual(s) who is, or are, not otherwise involved in the work in question and who would have had the appropriate experience and expertise to take responsibility for the work themselves.
IELR	Initial expected loss ratio.
IFRS	International Financial Reporting Standards (“IFRS”) form a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.
IID	International Insurers Department, a department within the NAIC.

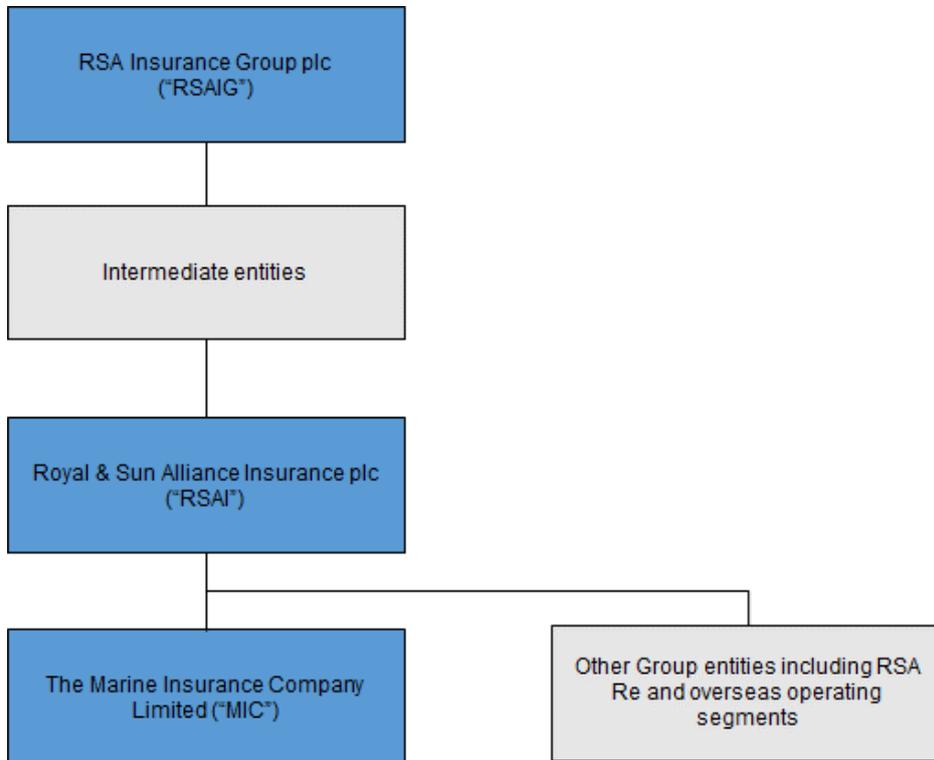
ILU	The Institute of London Underwriters, the former trade association for the company market specialising in marine, aviation and transportation insurance business in London; established in 1884, the ILU required guarantees for company members writing marine insurance and reinsurance business in London. When the ILU and LIRMA (the London Insurance and Reinsurance Market Association, which was the trade association acting for non-marine insurance companies), merged in December 1998 to form the IUA (the International Underwriting Association of London), the ILU retained responsibility for the parental guarantees given by companies who had been members of the ILU. The ILU's then members ceased their membership of ILU and became members of the IUA.
ILU Guarantee	An ILU guarantee was the guarantee required by the ILU for company members writing marine insurance and reinsurance business in London.
KRH	KaylaRe Holdings Limited, a member of the Enstar Group, and the parent of KaylaRe Ltd.
LOC	Letter of Credit, which is a letter from a bank guaranteeing that a due payment (e.g. in respect of an insurer's liability under an insurance policy) will be met fully on production of the LOC.
LPT	Loss Portfolio Transfer, a reinsurance agreement under which all or a distinct part of an insurer's existing insurance liabilities are 100% reinsured by a third party.
MIC	The Marine Insurance Company Limited, a subsidiary of RSAI.
Mercantile	Mercantile Indemnity Company Limited, a member of the Enstar Group.
MCR	The Solvency II Minimum Capital Requirement ("MCR") is lower than the SCR, and defines the point of intensive regulatory intervention. The MCR calculation is less risk sensitive than the SCR calculation and is calibrated to a confidence level of 85% over one year (compared to 99.5% for the SCR).
Migration Date	The date on which the Separation and Migration Plan is successfully completed and implemented.
Milliman	Milliman LLP, a member of the Milliman Group.
The Milliman Group	The group of entities whose ultimate parent is Milliman, Inc.
MRNA	Maiden Reinsurance North American, Inc., an insurance company domiciled in Missouri.
MSM	Minimum Margin of Solvency, the absolute floor of the required solvency requirement for insurers regulated in Bermuda. The amount of the MSM for an insurer is determined by its Class under the Insurance Returns and Solvency Regulations 1980.
NAIC	National Association of Insurance Commissioners, which is the standard-setting and regulatory support organisation in the USA created and governed by the chief insurance regulators from each of the states plus the US territories.
NIHL	Noise induced hearing loss, a type of industrial disease.
Non-Transferred Policy	A contract of insurance (if any) written or assumed by RSAI or by MIC under which any liability remains unsatisfied or outstanding as at the Effective Date and which would have formed part of the Transferring Business but which, for any reason, is not transferred by order of the Court pursuant to Part VII of FSMA on the Effective Date. I have referred separately to such a policy as a RSAI Non-Transferred Policy if it emanates from RSAI and as a MIC Non-Transferred Policy if it emanates from MIC.
OECA	Own Economic Capital Assessment.
Ogden Rate	The colloquial term given to the discount rate applied when calculating lump sum payments in respect of personal injury claims.
ORSA	The Own Risk Solvency Assessment ("ORSA") is a fundamental set of processes under Solvency II constituting a tool for decision-making and strategic analysis. It aims to assess, in a continuous and prospective way, the overall solvency needs related to the specific risk profile of the insurance company.
Outsourcing Agreement	An agreement between RSAI and Mercantile whereby Mercantile will outsource to RSAI the servicing of the Transferring Business from the Effective Date until the Migration Date. As at

	the date of this Report, the term sheet for the Outsourcing Agreement has been agreed between RSAI and Mercantile but the agreement itself has yet to be signed.
Own Funds	In Solvency II terminology, the amount of capital or excess assets of an insurance company. Own funds are divided into basic own funds and ancillary own funds (e.g. unpaid share capital), which require regulatory approval.
Part VII Transfer	An insurance business transfer scheme performed in accordance with the requirements set out in Part VII of FSMA.
Pelican+	A new IT platform being developed by the Enstar Group onto which will be transferred the data relating to the commercial liability parts of the Transferring Business.
PL	Public Liability, a form of commercial insurance that protects commercial enterprises against claims of personal injury or property damage that a third party suffers (or claims to have suffered) as a result of the business activities of the insured.
The Policy Statement	The Statement of Policy issued by the PRA entitled The Prudential Regulation Authority's approach to insurance business transfers, issued in April 2015.
PPO	Periodical Payment Order, a form of structured settlement that can be imposed on the parties to a personal injury claim by UK courts.
PRA	The Prudential Regulation Authority ("PRA") is part of the Bank of England and carries out the prudential regulation of financial firms in the UK, including banks, investment banks, building societies and insurance companies. The PRA operates as part of the regulatory framework implemented under the Financial Services Act 2012.
Pro	Pro Global Solutions Limited.
Project Silver	The term given by the RSA Group to the project to sell and transfer to a third party (subsequently agreed to be Mercantile) the Transferring Business.
QBE	QBE Insurance Group Limited.
QRTs	Quantitative Reporting Templates, which must be completed by insurers and submitted to the regulator on a regular basis in accordance with Solvency II. The QRTs cover a wide range of quantitative financial information about the insurer including details of its balance sheet, capital requirements and reserves.
Required Capital	The amount of capital an insurer must hold in order to meet its regulatory capital requirements (for example the SCR).
Reinsurance	An arrangement with another insurer whereby risks are shared (or passed on). If reinsurance is termed as being "inwards" then the reinsurer in question has accepted risk from an(other) (re)insurer; if reinsurance is termed as being "outwards" then the (re)insurer in question has passed risk to a(nother) reinsurer.
The Reinsurance Agreement	The agreement entered into on 7 February 2017 by RSAI and Fitzwilliam whereby, with effect from 31 December 2016, the RSAI Transferring Business plus RSAI's 100% reinsurance of the MIC Transferring Business was wholly reinsured by Fitzwilliam. The Reinsurance Agreement has subsequently been novated from Fitzwilliam to Cavello Bay.
Reinsurance Oversight Committee	This committee, comprising three representatives from each of RSAI and the Enstar Group, is responsible for overseeing the management of all practical and day-to-day operational matters relating to the Reinsurance Agreement.
Report	References to the "Report" refer to this report.
The Report Summary	The summary of this Report, prepared specifically to be included in a document that also summarises the Scheme and which will be made available to policyholders of RSAI and MIC and to others who might be affected by the Scheme.
RMF	This refers to a common Risk Management Framework that operates across the Enstar Group.
RSA Group	A collective term for RSAIG and its direct and indirect subsidiaries.
RSA Re	Royal & Sun Alliance Reinsurance Limited, a member of the RSA Group.

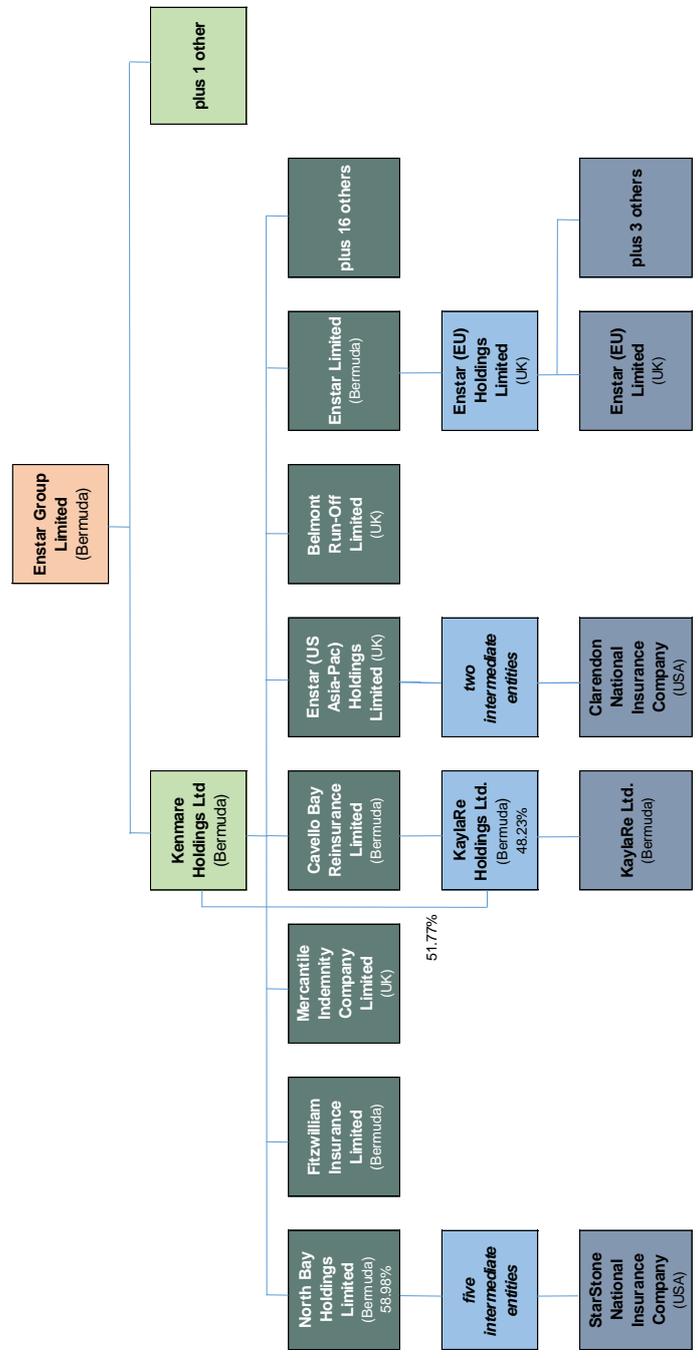
RSA Group Internal Model	The internal model developed, maintained and used by RSAIG and its subsidiaries for business planning and solvency capital estimation purposes.
RSAI	Royal & Sun Alliance Insurance plc, an indirect subsidiary of RSAIG.
RSAIG	RSAI Insurance Group plc (“RSAIG”), the ultimate parent company of the RSA Group.
RSAL	This is the term used to denote the insurance company that RSAI proposes establishing in Luxembourg, into which RSAI intends transferring its non-UK EU business and which, post-Brexit, will write its non-UK EU business.
The Scheme	In the context of this Report, the proposal that the transferring business of RSAI and of MIC be transferred to Mercantile under the provisions of Part VII of FSMA.
Separation and Migration Plan	A plan, jointly developed by RSAI and Enstar, for the transfer from RSAI and MIC systems to Mercantile systems of the claims and policy information relating to the Transferring Business. This includes the development, where necessary, of Mercantile systems that are appropriate for handling these policy and claims records.
SFCR	Each insurer is expected to publish a Solvency Financial Condition Report (“SFCR”) annually, which will contain certain qualitative and quantitative information, the quantitative information being in the format of certain prescribed QRTs.
Solvency I	The system for establishing minimum capital requirements for EU (re)insurers under relevant EU Directives prior to the introduction of Solvency II on 1 January 2016.
Solvency II	The system for establishing (among other things) minimum capital requirements for EU (re)insurers under the Solvency II Directive 2009/138/EC.
SCR	The Solvency Capital Requirement (“SCR”) under Solvency II is the amount of capital required to ensure continued solvency over a one-year trading period with a likelihood of 99.5%.
SLTF	Excess and Surplus Lines Trust Fund.
SNIC	StarStone National Insurance Company, a member of the Enstar Group.
SUP18	Section 18 of the FCA Supervision Manual.
Supplementary Report	A report I will prepare in advance of the Court hearing to sanction the Scheme covering any relevant matters that might have arisen since the date of this Report.
TCF	The TCF (‘treating customers fairly’) principles aim to raise standards in the way firms carry on their business by introducing changes that will benefit consumers and increase their confidence in the financial services industry. Specifically, TCF aims to: help customers fully understand the features, benefits, risks and costs of the financial products they buy; and minimise the sale of unsuitable products by encouraging best practice before, during and after a sale.
TCL	Target Capital Level, the level of capital at which the BMA wishes to see (re)insurers that it regulates operating. This is expressed as a proportion of the ECR.
Technical Provisions	Liabilities determined for regulatory purposes. In particular, the provisions for the ultimate costs of settling all claims arising from events that have occurred up to the balance sheet date, including provision for claims incurred but not yet reported, less any amounts paid in respect of these claims; plus the provisions for future claims (and premiums) arising on unexpired periods of risk (see Appendix H for further details).
TOGC	Transfer of a Business as a Going Concern. This is an HMRC term that relates to transfers of business that satisfy certain tests and that are therefore subject to specific treatment for tax purposes.
The Tower Pool business	This refers to a small block of run-off business that was transferred from RSAI to Knapton Insurance Limited in 2015. This business had originally been written by Phoenix Assurance Public Limited Company through its participation in an underwriting pool known as the Tower Pool, which was active between 1967 and 1972, and had subsequently been transferred to RSAI.
Transfer Document	The document that sets out the terms of the Scheme.

Transferee	The insurer to which business is being transferred – in the case of the Scheme this is Mercantile.
Transferors	The insurers from which business is being transferred – in the case of the Scheme these are RSAI and MIC.
Transferring Assets	The assets of RSAI and MIC that are to be transferred to Mercantile under the Scheme.
Transferring Business	The business of RSAI and MIC that is to be transferred to Mercantile under the Scheme. I have referred separately to such business as RSAI Transferring Business if it is currently covered by RSAI (this excludes RSAI's reinsurance of the MIC Transferring Business) and as MIC Transferring Business if it is currently covered by MIC.
Transferring Policyholders	The policyholders of the Transferring Business. I have referred separately to such policyholders as RSAI Transferring Policyholders if they are currently covered by RSAI and as MIC Transferring Policyholders if they are currently covered by MIC.
TSA	Transitional Services Arrangements.
TUPE	Transfer of Undertakings (Protection of Employment) Regulations 2006.
ULAE	Unallocated loss adjustment expenses, i.e. claim-related costs that cannot be allocated specifically to individual claims, such as the costs of running a claims team.
Underwriting Year	The year to which a claim is allocated based on the date the policy was written.
USD	US Dollars.
US Surplus Lines insurance business	Such business arises within a particular US state when either insurance capacity is limited or there is no specific appetite for a particular risk or line of business to be underwritten by the licensed or admitted domestic insurance companies. In such events insurance may be placed "out of state" with eligible insurers from other US states or from outside the USA.
VAT	Value Added Tax.
Work Review	Process by which a piece of actuarial work is considered by at least one other individual for the purpose of providing assurance as to the quality of the work in question.
Zurich	Zurich Insurance Group Limited.

APPENDIX B CORPORATE STRUCTURE OF THE RSA GROUP



APPENDIX C CORPORATE STRUCTURE OF THOSE PARTS OF THE ENSTAR GROUP THAT ARE RELEVANT TO THE SCHEME



Ownership of those subsidiaries named is 100% unless stated otherwise. Readers should note that the different colours have been selected to make the schematic easier to review. Otherwise, they have no particular significance.

APPENDIX D CV FOR DEREK NEWTON

- D.1. Derek Newton is a principal and actuarial consultant in Milliman's London office. He is leader of Milliman's UK General Insurance practice. He joined the firm in 2003.
- D.2. Derek started his actuarial career in 1983. Since 1994 he has worked exclusively within General Insurance, where he has experience with reserving, mergers and acquisitions (M&A) activity, portfolio transfers, Solvency II, the underwriting process, management reporting, designing and evaluating risk transfer mechanisms, premium rating, risk modelling, and capital and solvency evaluation. His experience includes:
- Leading teams reviewing reserves (and the internal reserving processes) for various insurers and reinsurers, including, where relevant providing statements of actuarial opinion for Lloyd's, for the Central Bank of Ireland, for the Bermudan Monetary Authority and for the relevant US insurance departments.
 - Assisting insurers with the preparation of solvency capital assessments, both internal and in accordance with prevailing regulatory requirements.
 - Leading assignments to review the underwriting effectiveness of several insurance operations, both commercial and personal lines, resulting in improved efficiency and additional profits to the insurers.
 - Providing independent expert support to insurers arranging transfers of business between themselves (see below).
 - Providing Actuarial Function support to several insurers.
 - Leading the evaluation of the reinsurance strategy and reinsurance programme for a major insurer.
 - Leading the review of various European insurers as part of due diligence assignments
- D.3. Of particular relevance in this context, Derek acted as the independent expert in respect of the following Part VII transfers:
- The transfer of the general insurance business of RL(CIS) Limited to CIS General Insurance Limited, a transfer that was sanctioned in 2014;
 - The transfer of general insurance business relating to the Tower pool from RSAI to Knapton Insurance Limited, a transfer that was sanctioned in 2015;
 - The transfer of the general insurance business of Dowa Insurance Company (Europe) Limited to Aioi Nissay Dowa Insurance Company of Europe Limited, a transfer that was sanctioned in 2016;
 - The transfer of general insurance business relating to the Ridgwell, Fox & Partners pool from QBE Insurance (Europe) Limited and from Moorgate Insurance Company Limited to Bothnia International Insurance Company Limited, a transfer that was sanctioned in 2017.
- D.4. In addition, Derek has been peer reviewer to the Independent Expert in the following transfers.
- the business of various UK-regulated subsidiaries of RSAIG to a smaller number of UK-regulated subsidiaries of RSAIG. The transfers were approved by the Court on 12 December 2011
 - the business of PA(GI) Limited to RSAI and to MIC. The transfers were approved by the Court on 12 December 2011
 - certain business of the Italian branch of Sompo Japan Insurance Company of Europe Limited to Berkshire Hathaway International Insurance Limited. The transfer was effective 31 March 2013
 - the business of Chevanstell Limited to R&Q Insurance (Malta) Limited. The transfer was effective 31 December 2013

- the European branch business of Mitsui Sumitomo Insurance Company (Europe) Limited to MSIG Insurance Europe AG. The transfer was effective 31 December 2013.

D.5. Before joining Milliman, Derek was:

- A director of Heath Lambert's ART division (2002-2003)
- A partner within Ernst & Young's UK property & casualty consulting practice (1998-2001)
- In a variety of roles within Prudential plc (1983-1998), culminating in finance director and actuary for Prudential's UK general insurance operation.

D.6. Derek was awarded Fellowship of the Institute of Actuaries in 1988. He was a member of the General Insurance Board of the Institute & Faculty of Actuaries (2002-2014) and chaired the Board 2005-2007. He also served on the Council of the Institute of Actuaries (2005-2010). He has chaired various actuarial working parties and authored or co-authored several papers. In 2013 Derek received a special award from the profession to mark his Outstanding Contribution to General Insurance Research.

APPENDIX E SCOPE OF THE WORK OF THE INDEPENDENT EXPERT IN RELATION TO THE SCHEME

E.1. The following was included within the letter of engagement that was agreed between the Companies, Milliman and me, and that was shown to the PRA prior to the approval by the PRA and FCA of my appointment as the Independent Expert in respect of the Scheme. As such the following constitutes my terms of reference in respect of this assignment.

“My report(s) will consider the terms of the Scheme generally and the effect which the Scheme will have on the holders of (re)insurance policies of the Companies.

My review and report(s) will address generally the way in which the Companies have conducted their (re)insurance business but taking into account the particular circumstances of each of the different groups of policyholders of the Companies involved in the Scheme. It will deal inter alia with the following aspects:

- The likely scope for deteriorations in each of the Companies' claims reserves (i.e. the likelihood and extent to which each of the Companies' reserves may prove inadequate);*
- The impact of the Scheme on the security/financial strength afforded the different groups of policyholders of the Companies involved in the Scheme;*
- The corporate governance structures operating in the Companies involved in the Scheme and the impact on the different groups of policyholders in the Companies involved in the Scheme;*
- The impact of the Scheme on the levels of service provided to the different groups of policyholders of the Companies involved in the Scheme;*
- The existing and proposed agreements between the Companies and their reinsurers;*
- Guarantees and/or agreements (if any) between the Companies;*
- Guarantees and/or agreements (if any) between each of the Companies and their respective parent company;*
- Transactions (outside the Scheme) that impact upon one or both of the Companies;*
- The terms and conditions (if any) expected to be imposed by the Scheme to be presented to the Court;*
- The matters required by applicable provisions of the PRA's Policy Statement PS7/15 and Chapter 18 of the supervision manual in the FCA's Handbook;*
- A review of the communications made to policyholders;*
- Any other matters drawn to my attention by the Regulators or which are required by the Regulators to be addressed within the report(s).*

The above list is not intended to be exclusive to any other aspects which may be identified during the completion of the project and which are considered to be relevant.

I shall not be directly involved in the formulation of the proposed transfers although I should expect to give guidance during the evolution of the detailed proposals on those issues which concern me, or which I consider unsatisfactory.

I will meet with the Companies at an early stage to identify key issues.

I will support the Companies in their liaison with and provision of information to the Regulators and share the Part VII Report(s) (and drafts) and any supplemental report with those noted at paragraph 6(b) of the engagement letter.

I will not provide any advice with respect to the merits of the proposed Scheme.”

APPENDIX F GENERAL CONSIDERATIONS OF THE INDEPENDENT EXPERT

INTRODUCTION

- F.1. I have compiled my Report in accordance with the Policy Statement and with SUP18.
- F.2. Under FSMA, the concept of TCF must be applied. To help ensure that customers are treated fairly in the future it is necessary to understand how they have been treated in the past. From the policyholders' perspective, the acceptability of the Scheme must be on the basis that it will not have a materially adverse effect on their benefits or fair treatment.
- F.3. In order to fulfil my obligations as Independent Expert I have considered the terms of the Scheme generally and how the different groups of policyholders are likely to be affected by the Scheme. In particular, I have considered:
- The likely effects of the Scheme on the security of the policyholders' benefits, including the likelihood and potential effects of the insolvency of the insurer; and
 - The likely effects of the Scheme on policyholder servicing levels (e.g. claims handling).

Materiality

- F.4. After considering the effects of the Scheme on each of the different groups of policyholders affected by the Scheme (as identified in paragraph 5.20 above), I have drawn conclusions as to whether I believe the Scheme will materially adversely affect that group of policyholders. It should be recognised that the Scheme will affect different policyholders in different ways, and, for any one group of policyholders, there may be some effects of the Scheme that are positive, and others that are adverse. If some effects of the Scheme are adverse, that does not necessarily mean that the Scheme is unreasonable or unfair, as those adverse effects may be insignificant or they may be outweighed by positive effects.
- F.5. In order to determine whether any effects of the Scheme on any group of policyholders are *materially* adverse it has been necessary for me to exercise my professional judgement in the light of the information that I have reviewed.
- F.6. When assessing the financial security of policyholders, I have looked at the solvency position of the companies involved in the Scheme, on both pre- and post-transfer bases, relative to regulatory solvency requirements, and also at the nature of the assets that constitute each company's capital and surplus. It should be noted that a company may have capital considerably in excess of its regulatory requirements, but that the directors of a company could legitimately reduce that level of capital (for example through the payment of dividends) and still leave the company appropriately capitalised. In circumstances where the Scheme has adversely affected the financial security of a group of policyholders, in order to determine whether that impact is material, I have considered whether the level of financial security projected to be in place after the transfer would have been acceptable and permissible before the transfer had taken place. I would determine that any adverse impact to a particular group of policyholders is material if the level of financial security afforded to them after the transfer would not have been acceptable under the normal constraints under which the company's capital position was managed before the transfer.

SECURITY OF POLICYHOLDER BENEFITS

- F.7. As noted above, I need to consider the security of policyholder benefits, i.e. the likelihood that policyholders will receive their benefits when due.
- F.8. In considering and commenting upon policyholder security I shall consider the financial strength of each entity. Financial strength is provided by the margins for prudence in the assumptions used to calculate the Technical Provisions, by the shareholder capital and by any specific arrangements for the provision of financial support. In considering policyholder security it is also necessary to take into account the potential variability of future experience (including claim frequency and severity). Security is also affected by the nature and volume of future new business.
- F.9. The main factors that determine the risks to which a policyholder is exposed are:
- Size of company;

- Amount of capital held, other calls on that capital and capital support currently available to the company;
- Reserve strength;
- Mix of business written; and
- Company strategy – for example, whether it is open or closed to new business.

F.10. I also need to consider the impact on policyholders' security in the event of the default of an insurer (e.g. the role of the FSCS).

TREATING CUSTOMERS FAIRLY

F.11. As Independent Expert I also need to consider the impact of the Scheme on levels of service provided to policyholders, including those resulting from changes in administration, claims handling and expense levels.

F.12. Further, I have considered the proposals in the context of applicable conduct rules/regulation, e.g. the fair resolution of complaints between an insurer and its customers (policyholders).

OTHER CONSIDERATIONS

F.13. Paragraph 2.34(4)(b) of the Policy Statement and paragraph 2.36 of SUP18 both require me, as Independent Expert, to consider the likely effects of the Scheme on matters such as investment management, new business, administration, expense levels and valuation bases insofar as they might impact on levels of service to policyholders or on the security of policyholders' benefits.

F.14. I am also required to consider the cost of the Scheme and the tax effects of the Scheme insofar as they might impact on the security of policyholders' benefits.

APPENDIX G KEY SOURCES OF DATA

G.1. In writing this Report, I relied upon the accuracy of certain documents provided by RSAI, MIC and Enstar. These included, but were not limited to, the following:

- Draft Transfer Document
- Draft witness statements from RSAI and MIC and from Mercantile
- The BTA
- The BTA Disclosure Letter, dated 7 February 2017, from RSAI and MIC to Belmont
- An agreement letter from RSAI and MIC to EGL, Belmont, Mercantile, Fitzwilliam and Cavello Bay, dated 27 April 2017, which novated the BTA from Belmont to Mercantile
- The Reinsurance Agreement, dated 7 February 2017, between RSAI and Fitzwilliam and Cavello Bay
- The Reinsurance Disclosure Letter, dated 7 February 2017, from Fitzwilliam to RSAI
- The Deed of Guarantee, dated 7 February 2017, between EGL and RSAI and MIC
- The Deed of Release, dated 3 May 2017, between Fitzwilliam and RSAI
- Collateral and Security Deed, dated 28 April 2017, between Cavello Bay and RSAI
- A draft (dated 29 June 2018) of the Deed of Amendment between Mercantile, Cavello Bay and EGL, which sets out the changes to the Reinsurance Agreement and to Collateral and Security Deed that will take effect from completion of the Scheme
- Written notice from the PRA stating that it had agreed to vary the permission of Mercantile in regards to certain specified regulated activity, customer types, investment types and limitation, with effect from 30 July 2018
- A letter from Locke Lord LLP, dated 18 October 2017 and addressed to RSAIG and MIC, setting out Locke Lord's views on the effectiveness/recognition in the US of a Court order
- A letter from PwC to HMRC, dated 31 March 2017, headed *RSA Insurance Group plc – Request for non-statutory clearance*, and a response from HMRC, dated 12 April 2017
- A document entitled *Migration Overview* dated October 2017
- A draft letter dated 27 November 2018 setting out the Term Sheet for the Outsourcing Agreement between RSAI and Mercantile
- A document entitled *Part VII Court Scheme Transfer Provisional Communication Strategy*, dated 28 September 2017, and a further document entitled *Communications Plan Framework* and dated 16 October 2017.
- Draft letters (as at 23 October 2017) to recipients of the Communications Pack, specifically to policyholders or claimants in relation to the Transferring Business, to brokers who brokered the Transferring Business, to reinsurers of either RSAI or MIC in respect of some element of the Transferring Business, to lawyers who had represented a client in respect of a claim or action relating to the Transferring Business, and to members of APIL.
- Draft Scheme Summary
- Draft Frequently Asked Questions, for provision to the policyholders as part of the Communications Pack.

RSAIG

- SFCR 2017

- Executive Summary to the 2016 Group ORSA Report, dated 21 June 2016
- Executive Summary to the 2017 Group ORSA Report, dated June 2017
- Group ORSA Report 2016, dated 11 July 2016
- Group ORSA Report 2017, dated 30 August 2017
- Group ORSA Report 2018, dated 20 June 2018
- Capital projections for RSAI as at the year-ends 2017, 2018 and 2019, based on the RSAI business plan approved on 23 February 2017
- QRT S.23.01.04 for RSAIG, and QRTs S.23.01.01 for RSAI and MIC as at 31 March 2018

RSAI

- Audited report and accounts for RSAI as at 31 December 2017
- System of Governance document, dated December 2017
- Powerpoint slides setting out RSAI's planned approach to Brexit
- Powerpoint slides setting out RSAI's asbestos modelling approach

MIC

- Audited report and accounts for MIC as at 31 December 2017
- System of Governance document, dated December 2015
- Deed of Guarantee, dated 16 December 2011, between RSAI and the ILU

RSAI and MIC

- Reserve analysis for the Transferring Business as at 31 December 2017 and as at 31 March 2018
- Information Memorandum, dated August 2016, for Project Silver
- Project Silver Bidder Management Presentation, dated 31 January 2017
- Reports on reserves prepared by external actuaries, on GAUM (as at 30 June 2015, and dated 9 October 2015), on UK Asbestos for EL (as at 31 December 2014, and dated 24 February 2015), on UK Asbestos for PL (as at 31 December 2014, and dated 24 February 2015), on UK Asbestos for Timber & General (as at 31 December 2014, and dated 24 February 2015), and on EL and PL as at 30 June 2015, dated 7 January 2016)
- Papers for the each quarterly Legacy Reserving Overview Meeting, from the first quarter 2017 to the second quarter 2018, including various spreadsheets that supported the reserve estimates contained therein
- Documents describing, and showing the results of, modelling undertaken by RSAI to show the estimated distribution of the unpaid liabilities of the Transferring Business as at 31 December 2017 and 31 March 2018.

Mercantile

- Audited report and accounts for Mercantile as at 31 December 2017
- Regulatory Business Plan dated 15 June 2018
- Draft pro forma ORSA dated 24 October 2017
- Spreadsheet setting out on a pro forma basis the standard formula calculation of the SCR as at 31 December 2017, and projections for the subsequent 5 years

- An internal memorandum dated 23 May 2018 addressing the appropriateness of the standard formula approach to modelling reserve risk for Mercantile.
- Spreadsheet setting out on a pro forma basis the standard formula calculation of the OECA as at 31 December 2017, and projections for the subsequent 5 years
- A spreadsheet setting out the expected expenses of to be incurred in running-off the Transferring Business over the period from 2017 to exhaustion and a separate spreadsheet showing actual expenses incurred in 2017
- Sealed sanction order relating to the transfer of the remaining business in Mercantile (and others) to River Thames Insurance Company Limited, dated 7 April 2017

Cavello Bay

- Audited report and accounts for Cavello Bay as at 31 December 2017
- CISSA for the year ending 31 December 2017, dated 30 April 2018
- Pro forma balance sheets and capital projections for Cavello Bay as at 31 December 2017

EGL and the Enstar Group

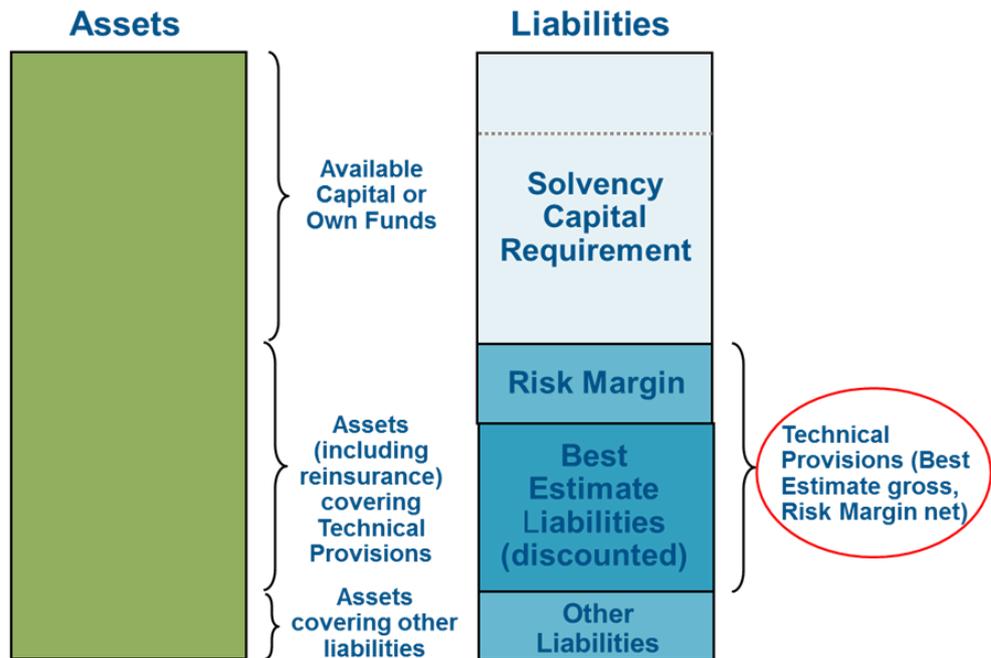
- Audited report and accounts for EGL as at 31 December 2017
- Enstar Group Structure Chart, as at 8 June 2017
- List of parental guarantees issued by EGL as at 30 June 2018
- GSSA for the year ending 31 December 2017, dated 1 May 2018
- A letter to Sam Woods at the PRA, dated 10 July 2017, explaining the Enstar Group's contingency planning for the UK's withdrawal from the European Union
- Code of Conduct, dated July 2016
- Conduct Risk Policy – Europe, dated December 2017
- Complaints Policy and Procedures – Europe, dated December 2017
- Conduct Risk Framework – Europe, dated December 2017

G.2. Information relating to the items listed above was also gathered during discussions with staff of RSAI and Enstar.

APPENDIX H SOLVENCY II BALANCE SHEET

H.1. A simplified illustration of a Solvency II balance sheet is shown in Figure H.1 below.

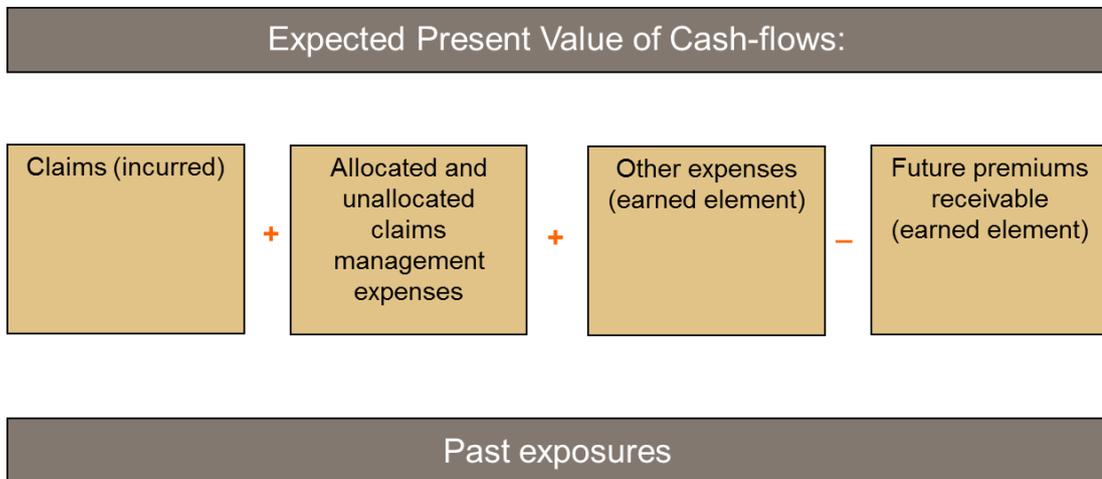
Figure H.1
Solvency II balance sheet



- H.2. The Solvency II balance sheet is intended to be a tool for management to assess an entity's solvency and hence an important consideration for significant decisions. It is also a tool for regulators to assess the solvency of an insurer.
- H.3. A key consideration for management in making significant decisions will be the excess of assets over Technical Provisions, other liabilities and the Solvency Capital Requirement (SCR). This excess of Own Funds over the SCR will determine whether the entity can expand existing business, move in to new areas, undertake mergers/acquisitions (with less capital rich entities) etc. or whether they need to consider reducing business volumes, moving out of capital intensive lines of business, purchasing additional reinsurance and so on. The level of Own Funds will also likely impact the credit rating of an entity.
- H.4. The Technical Provisions are a direct input to the balance sheet, and are therefore a fundamental input in to the SCR calculation that models the potential movement in the balance sheet over a one-year time horizon.
- H.5. Solvency II requires the Technical Provisions (as at the valuation date) to be determined using a market consistent valuation of the liabilities relating to insurance contracts. In practice, a market consistent liability valuation cannot be calculated by reference to market prices, because such prices are not (for practical purposes) available. Therefore Technical Provisions are presently estimated on a proxy to a market value basis, i.e. a 'best estimate' of the liabilities relating to insurance contracts allowing (i.e. discounting) for the time value of money supplemented by a risk margin. More specifically the Technical Provisions are made up as follows:
- Claims provision + Premium provision + Risk margin

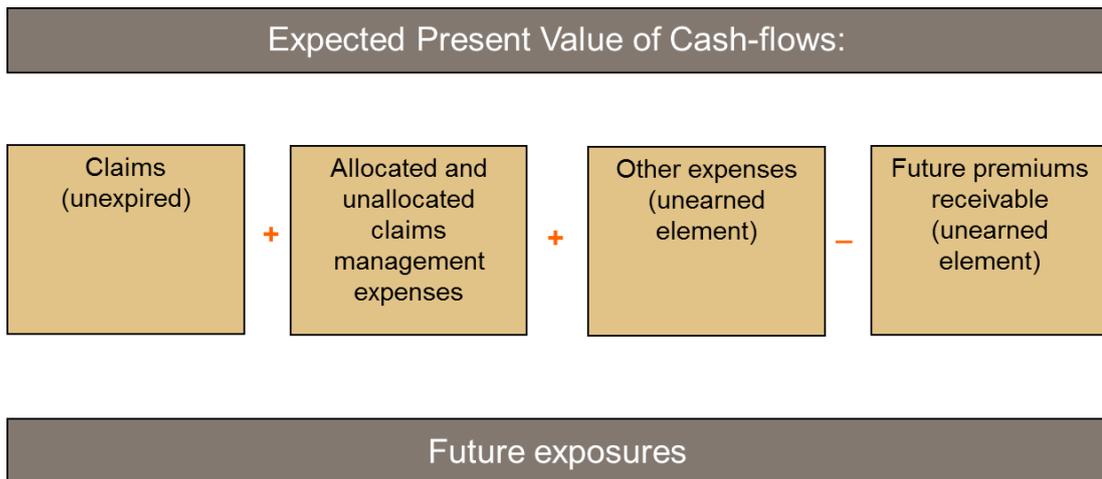
H.6. The claims provision is the expected present value/discounted ‘best estimate’ of all future cash-flows (claim payments, expenses and future premiums due) relating to claim events prior to the valuation date. Figure H.2 below illustrates the components of the claims provision calculation.

**Figure H.2
Claim Provision**



H.7. The premium provision is the expected present value/discounted ‘best estimate’ of all future cash-flows (claim payments, expenses and future premiums due) relating to future exposures arising from policies that the insurer is obligated to at the valuation date. Figure H.3 below illustrates the components of the premium provision calculation.

**Figure H.3
Premium Provision**



-
- H.8. The risk margin ('RM') is intended to be the balance that another (re)insurer taking on the liabilities at the valuation date would require over and above the discounted 'best estimate'. Under Solvency II, the RM is calculated using a cost-of-capital ('CoC') approach (presently employing a 6% CoC parameter as provided by EIOPA). More specifically, the calculation is as follows:

$$RM = CoC \times \sum_{t \geq 0} \frac{SCR(t)}{(1 + r_{t+1})^{t+1}}$$

where:

SCR(t) as employed for the RM formula consists of underwriting risk (with respect to existing business); counterparty risk (e.g. reinsurance); operational risk; and market risk (if unavoidable, i.e. not hedge-able); and

r_t is the risk-free discount rate(s) at time t, as provided by EIOPA for all major currencies.