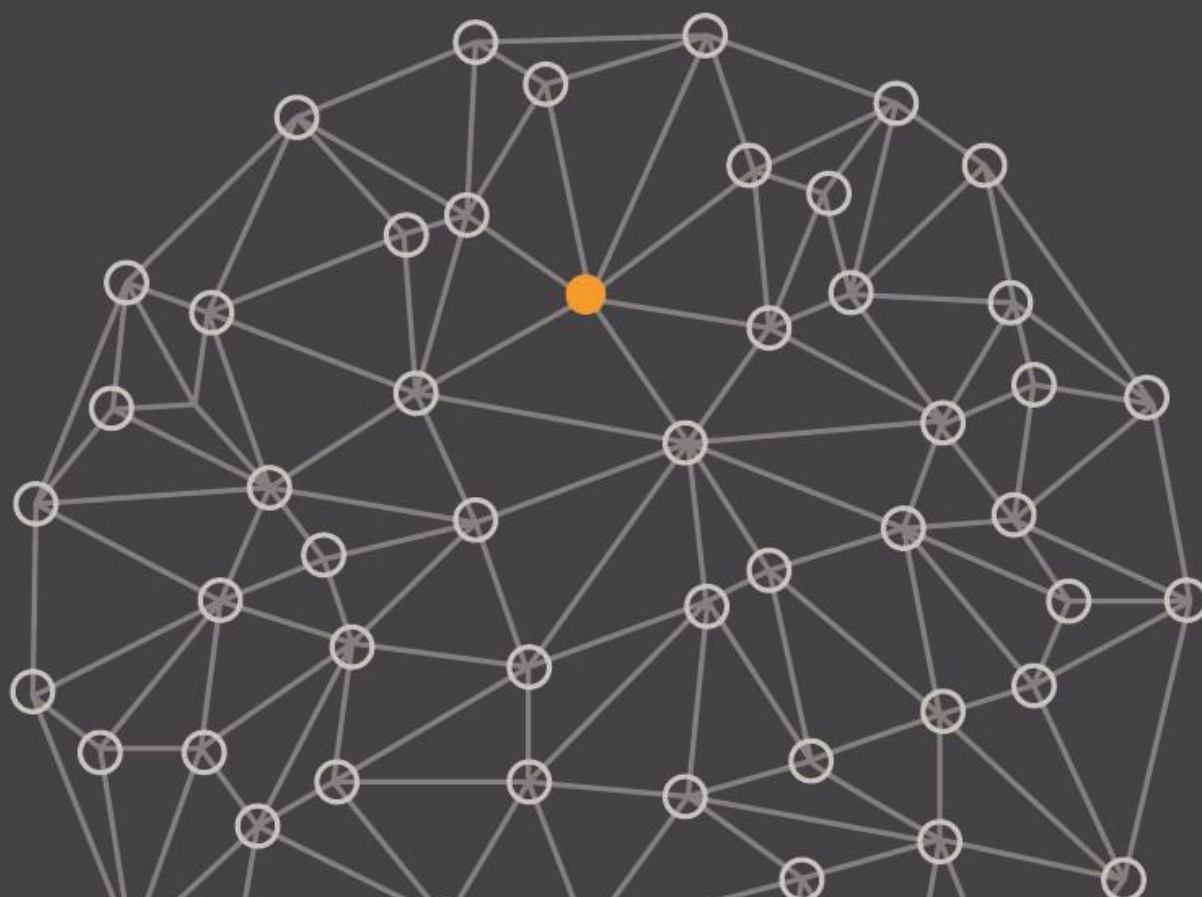


The North of England Protecting and Indemnity Association Limited

Report of the Independent Expert on the proposed transfer of business
from Sunderland Marine Insurance Company Limited to The North of
England Protecting and Indemnity Association Limited

18 February 2020



Derek Newton, FIA



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1. Purpose and Scope

PURPOSE OF THIS REPORT

- 1.1 It is proposed that the business of Sunderland Marine Insurance Company Limited ("SMI" or the "Transferor") be transferred to The North of England Protecting and Indemnity Association Limited ("NOE" or the "Transferee") by an insurance business transfer scheme ("the Scheme"), as defined in Section 105 of the Financial Services and Markets Act 2000 ("FSMA"). In this report, I refer to any such business transfer scheme as a "Part VII Transfer".
- 1.2 Some of SMI's insurance business was written in circumstances that required SMI to be authorised under Jersey law, because it was insurance business carried on in or from within Jersey ("SMI's Jersey Business"). It is also proposed that SMI's Jersey Business be transferred to NOE by an insurance business transfer scheme (the "Jersey Scheme"), pursuant to Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996.
- 1.3 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 ("FSMA Report"). The FSMA Report must be prepared by an independent person (the "Independent Expert") who has the skills necessary to make the report and who is nominated or approved by the Prudential Regulation Authority ("PRA"), the 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. Similarly, paragraph 3 of Schedule 2 of the Insurance Business (Jersey) Law 1996 requires that an application to the Royal Court of Jersey ("the Jersey Court") for an order sanctioning an insurance business transfer scheme must be accompanied by a report on the terms of the Jersey Scheme ("the Jersey Report"), prepared by an independent actuary ("Independent Actuary").
- 1.4 I refer to SMI and NOE collectively as "the Companies". The Companies have nominated me to act as Independent Expert to provide the FSMA Report in respect of the Scheme, and the PRA, in consultation with the FCA, has approved my appointment (see paragraph 1.18, below). The Companies have also requested that I act as the Independent Actuary to provide the Jersey Report in respect of the Jersey Scheme.
- 1.5 This report (the "Report") describes the proposed transfer and discusses its possible effects on the policyholders of NOE and SMI (in respect of all business of NOE and SMI and also, specifically, in respect of SMI's Jersey Business), including its effects on the security of policyholder benefits and levels of service. As such, this Report fulfils the requirements of both the FSMA Report and the Jersey Report.
- 1.6 SMI and NOE are domiciled and authorised in the UK, where they are regulated by the PRA and FCA.
- 1.7 SMI has been a direct subsidiary of NOE since 28 February 2014, having entered into a strategic alliance with NOE in early 2012. In this Report, I refer to NOE and its direct and indirect subsidiaries collectively as the "North Group".
- 1.8 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 or of the Jersey Scheme (the "Transfer Documents"). Unless otherwise specified, references in the Report to the insurance business / policyholders of SMI and NOE are in respect of all general insurance and reinsurance business / policyholders of SMI and NOE, including SMI's Jersey Business.

THE SCHEME AND THE JERSEY SCHEME

- 1.9 Under the Scheme, it is intended that the business to be transferred to NOE (the "Transferring Business") comprises the entire remaining business underwritten by SMI¹. It will be transferred with all other liabilities and assets remaining within SMI ("Transferring Assets")².
- 1.10 Similarly, under the Jersey Scheme, the business to be transferred to NOE comprises all of SMI's Jersey Business remaining within SMI. It will be transferred with all other liabilities and assets remaining within SMI that relate to or support SMI's Jersey Business³.
- 1.11 The Effective Date of both the Scheme and the Jersey Scheme (collectively "the Schemes"⁴) is expected to be 30 June 2020.
- 1.12 Prior to becoming a wholly owned subsidiary of NOE, SMI demutualised. Pursuant to the terms of the demutualisation, the membership of the members of SMI was terminated and SMI members were released from any further liability to make contributions to the funds of SMI. As such, they became fixed premium, non-member policyholders of SMI. It is intended that, upon completion of the Schemes, the holders of policies within the Transferring Business (the "Transferring Policyholders"), who will include the holders of policies within SMI's Jersey Business, will become fixed premium, non-member policyholders of NOE.
- 1.13 The operational management of both the Transferring Business and the current business of NOE, including all policy administration, claims handling, etc., is currently conducted by staff employed by North Group Services Limited ("NGSL")⁵. NGSL is a group employee holding company that is a wholly owned subsidiary of NOE. Post-Schemes, both the Transferring Business and the current business of NOE will continue to be administered and serviced by employees of NGSL, as directed by NOE rather than by SMI, with no change to the personnel administering and servicing SMI policies and claims. There will be no migration of data from one administration system to another because NGSL employees will continue to use the existing IT systems.
- 1.14 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 9 of this Report.
- 1.15 NOE and SMI are both currently entitled to underwrite non-UK business in the European Economic Area ("EEA") on a freedom of services basis under the Financial Services passporting regime of the European Union ("EU"). It is anticipated that, following the UK ceasing to be a member of the EU ("Brexit"), NOE and SMI will lose their existing EEA passporting rights at the end of an agreed transition period (currently scheduled to end on 31 December 2020).
- 1.16 To ensure that, post-Brexit, the North Group continues to be have access to EEA markets, NOE has established a wholly owned subsidiary insurance company, North of England P&I Designated Activity Company ("North EU"), in the Republic of Ireland and regulated by the Central Bank of Ireland. Since 20 February 2019, North EU has underwritten (nearly⁶) all non-UK EEA insurance business on behalf of the North Group, with NOE and SMI continuing to underwrite non-EEA business, as well as running off existing non-UK EEA business underwritten prior to 20 February 2019.

¹ In practice, some business might remain within SMI post the Effective Date, although it is intended that such business be minimal and run-off or transferred to NOE by other means as soon as possible after the Effective Date. This is discussed in more detail in paragraphs 5.35-5.38 and in Section 7 below.

² In practice, SMI will retain assets post the Effective Date, both as reserves in respect of any business remaining within SMI until such time that such business has been run-off or transferred to NOE by other means and as capital to meet the solvency requirements of the relevant regulators. The regulators will typically not permit such capital to be released until all relevant liabilities have been run-off or transferred and the permissions withdrawn.

³ SMI's Jersey Business is not contained within a separate legal entity. The assets supporting the liabilities of SMI's Jersey Business are not segregated from the assets supporting SMI's other liabilities.

⁴ The Scheme is intended to transfer to NOE all of the business of SMI, whereas the Jersey Scheme is intended to transfer to NOE just the Jersey business of SMI. As such, if sanctioned, the Scheme will transfer SMI's Jersey business to NOE, subject to the sanctioning of the Jersey Scheme. If the Scheme were sanctioned but the Jersey Scheme were then not sanctioned, then the Jersey business would be excluded from the transfer and would remain with SMI.

⁵ There is one exception to this. NOE staff in its Greek office did not transfer to NGSL along with all other members of NOE staff (and all SMI staff). They remain employed by NOE and continue to provide operational management to NOE's Greek business.

⁶ As at 20 February 2019, a small volume of non-UK EEA business was written by NOE, under a binder arrangement with the broker, Knighthood Corporate Assurance Services plc ("Knighthood").

- 1.17 A loss of passporting rights would jeopardise the North Group's ability to service its existing non-UK EEA business underwritten prior to 20 February 2019 or bound by Knighthood on behalf of NOE. In such an event, the North Group intends to effect (separate from the Scheme) a Part VII transfer to North EU of the non-UK EEA business underwritten by NOE or SMI prior to 20 February 2019. The North Group anticipates that, should such a transfer become necessary, work on it will not commence until the Scheme has been approved and effected. However, while it considers it would be logistically preferable that work on the Scheme and work on a Brexit transfer would take place sequentially, the North Group recognises that some such overlap might be necessary to ensure that any such Brexit transfer is fully effective. I note that I will not be acting as the independent expert in respect the Brexit transfer and will have no involvement in that transfer.

THE INDEPENDENT EXPERT

- 1.18 I, Derek Newton, have been appointed by SMI and NOE 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 1 December 2017. I have similarly been appointed by SMI and NOE as the Independent Actuary to consider the Jersey Scheme under Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996.
- 1.19 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 ("IFoA"), 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 such as Signing Actuary to Lloyd's syndicates and to Irish non-life insurance companies, as well as acting as the Independent Expert in five insurance business transfer schemes that were sanctioned in 2014, 2015, 2016, 2017 and 2019 respectively. I have included my Curriculum Vitae in Appendix C in which I explicitly note the insurance business transfer schemes for which I have acted as the Independent Expert, as well as those for which I have provided peer review support to the Independent Expert.
- 1.20 I do not have, and have never had, any direct or indirect interest in any of the parties involved in the proposed Schemes, and, to the best of my knowledge, have never had any such interest. I have never had any insurance policies with any of the companies within the North Group, and I am not a shareholder or member of NOE or of any other North Group entity. I have not previously acted in an advisory role to any North Group entity.
- 1.21 Milliman has no current business relationship with NOE or any other North Group entity. Other than indirectly through its work with the International Group of P&I Clubs (the "International Group"), I am unaware of any past business relationship between Milliman and the North Group. Milliman has undertaken no work for the International Group within at least the last eight years.
- 1.22 I believe that, for all practical purposes, I am independent for the purposes of assessing the proposed Schemes.
- 1.23 The Scheme is subject to sanction by the Court under Section 111 of FSMA. The Jersey Scheme is subject to sanction by the Royal Court of Jersey under Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996, and is conditional on the Scheme being effective.
- 1.24 NOE will meet the cost of my work as both Independent Expert and Independent Actuary. No costs of the Schemes will be borne directly by any of the policyholders of either SMI or NOE.

THE SCOPE OF MY REPORT

- 1.25 My terms of reference have been reviewed by the PRA and by the FCA and are set out in Appendix D.
- 1.26 I have considered the terms of the Schemes only and have not considered whether any other scheme or schemes or alternative arrangement might provide a more efficient or effective outcome.
- 1.27 The Report describes the Schemes and their likely effects on policyholders of SMI and NOE, including effects on the security of policyholders' benefits and levels of service.
- 1.28 The Report should be read in conjunction with the full terms of the Schemes.

- 1.29 My work has required an assessment of the liabilities of SMI and NOE for the purposes of describing the effect of the Schemes. My review of the liabilities was based on the actuarial reserve assessments conducted by external actuaries, on behalf of both SMI and NOE. I have reviewed the methodology and assumptions used in their work and assessed the key areas of uncertainty in relation to these liabilities. I have not attempted to review in detail the calculations performed by the external actuaries on behalf of SMI and NOE or to produce independent estimates of the liabilities.
- 1.30 In addition to the liabilities, I have assessed the appropriateness in nature and amount of any assets to be transferred under the Schemes, and the capital position of SMI and NOE both pre- and post-Schemes. Again, I have not attempted to review in detail the calculations of the capital position performed by NOE or SMI, and I have not attempted to produce independently my own estimates.
- 1.31 As far as I am aware, there are no matters that I have not taken into account in undertaking my assessment of the Schemes and in preparing this Report, but which nonetheless should be drawn to the attention of policyholders in their consideration of the Schemes.
- 1.32 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 SMI and / or to NOE. I confirm that I have complied with this duty.
- 1.33 Similarly, in reporting on the Jersey Scheme as the Independent Actuary, I recognise that I owe a duty to the Jersey Court to assist the Jersey Court on matters within my expertise. This duty overrides any obligation to SMI and / or to NOE. I confirm that I have complied with this duty.
- 1.34 I have taken account 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.
- 1.35 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.
- 1.36 Shortly before the date of the Court hearing at which an order sanctioning the Scheme will be sought, I will prepare a supplementary report ("Supplementary Report") that will cover any relevant matters that might have arisen since the date of this Report. As part of my preparation of the Supplementary Report, I shall review and comment on the then most up-to-date financial information relating to SMI and/or NOE.
- 1.37 The letters, notices and advertisements to be sent to policyholders or published in relation to the Schemes will refer all queries to a postal address or a telephone number or a website address. SMI and NOE have stated that they will respond promptly to any such queries. It is intended that both this Report and the Supplementary Report will be published on the NOE and SMI websites, on pages dedicated to the Schemes, and that copies will be sent to any policyholders who request them. Following the directions hearings relating to the Schemes, the Report will be published on the websites of SMI and of NOE, with copies being sent to any policyholders who request them. The Supplementary Report will likewise be made available at least one week before the dates of the hearings of the Court and of the Jersey Court at which the Schemes might be sanctioned.
- 1.38 I understand that the date of the Jersey Court hearing at which the Companies will seek an order sanctioning the Jersey Scheme will be immediately after the date of the Court hearing for the sanctioning of the Scheme. As I mentioned in paragraph 1.23, above, the Jersey Scheme will not go ahead if the Scheme has not been sanctioned by the Court.

Materiality

- 1.39 After considering the effects of the Schemes on each of the different groups of policyholders affected by the Schemes (as identified in paragraph 5.33 below), I have drawn conclusions as to whether I believe the Schemes will materially adversely affect that group of policyholders. It should be recognised that the Schemes will affect different policyholders in different ways, and that, for any one group of policyholders, there may be some effects of the Schemes that are positive and others that are adverse. If some effects of the Schemes are adverse, that does not necessarily mean that the Schemes are unreasonable or unfair, as those adverse effects may be insignificant or they may be outweighed by positive effects.

- 1.40 In order to determine whether any effects of the Schemes 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.
- 1.41 When assessing the financial security of policyholders, I have looked at the solvency position of the Companies, both pre- and post-Scheme, 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 relative to the normal constraints under which the company's capital position was managed before the transfer.

THE STRUCTURE OF MY REPORT

- 1.42 The remainder of this Report is set out as follows:
- Section 2: I provide an executive summary of this Report (I have also provided a separate summary of this Report, as described in paragraph 1.48, below).
 - Section 3: I provide some background information regarding the regulatory environment in which SMI and NOE operate.
 - Section 4: I provide some background information regarding SMI and NOE.
 - Section 5: I summarise the key provisions of the Schemes.
 - Section 6: I consider the likely impact of the Schemes on the Transferring Policyholders.
 - Section 7: I consider the likely impact of the Schemes on the policyholders who would remain within SMI after the transfer has taken place.
 - Section 8: I consider the likely impact of the Schemes on the current policyholders of NOE.
 - Section 9: I cover more general issues relating to the Schemes and the management of SMI and NOE.
- 1.43 I summarise my conclusions in Section 10.

RELIANCES AND LIMITATIONS

- 1.44 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 the Companies. 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 colleagues of mine at Milliman but I have not relied on their work or their advice. I note in paragraph 9.29, below, that I have seen some legal advice sought by SMI and NOE 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.
- 1.45 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. The Report has also been prepared for the purposes of the Jersey Scheme in accordance with Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996. A copy of the Report will accompany the Jersey Scheme application to the Jersey Court.
- 1.46 The Report must be considered in its entirety as individual sections, if considered in isolation, may be misconstrued.

- 1.47 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 Schemes and by the financial regulatory authorities in Jersey, 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 Schemes.
- 1.48 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 SMI and of NOE, to the lawyers and brokers dealing with or representing individual claimants in relation to the Transferring Business, to the affected reinsurers of SMI, 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 SMI or NOE of their interest (further details are provided in paragraphs 5.55-5.59, below). That document will be sent to the FCA and PRA, will accompany the Scheme application to the Court, and will be available on the website dedicated to the Schemes.
- 1.49 This Report has been prepared within the context of the assessment of the terms of the Schemes, and must not be relied upon for any other purpose. Milliman and/or I will accept no liability 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.
- 1.50 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.
- 1.51 This review does not comprise an audit of the financial resources and liabilities of SMI or NOE, or of the wider North Group.
- 1.52 The Report should not be construed as investment advice.
- 1.53 Nothing in this Report should be regarded as providing a legal opinion on the effectiveness of the Schemes.
- 1.54 In considering the background to the Companies, and in considering the likely impact of the Schemes, I have made extensive use of financial information as at 20 February 2019 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 publicly disclosed. I have asked the managements of the Companies for information regarding any developments between 20 February 2019 and the date of this Report that would have affected the 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 SMI and NOE have confirmed to 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 20 February 2019 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 any further financial statements of SMI and NOE, whether audited or unaudited, as and when they become available, and will comment on this information in my Supplementary Report.
- 1.55 All of the financial information with which I have been provided has been expressed in US Dollars. However, I would expect that some of the underlying assets and transactions would be or would have been denominated in other currencies. I presume that, throughout the financial information, data in other currencies has been converted to US Dollars at appropriate and mutually consistent currency exchange rates.

- 1.56 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

- 1.57 I am required to comply with relevant professional standards and guidance maintained by the Financial Reporting Council and by the IFoA, 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.
- 1.58 In accordance with *Actuarial Profession Standard X2*, as issued by the IFoA, 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.
- 1.59 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 (see Appendix F), 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 In my opinion, provided the proposed Schemes operate as intended, and I have no grounds for believing that they will not do so:
- Neither the Scheme nor the Jersey Scheme will materially adversely affect the security of benefits to policyholders of either SMI (both those policyholders being transferred under the Scheme and those who are holders of Residual Policies (as defined in paragraph 5.33, below) or NOE;
 - Neither the Scheme nor the Jersey Scheme will have an impact on service standards experienced by either the policyholders of SMI or the existing policyholders of NOE; and
 - Neither the Scheme nor the Jersey Scheme will result in any loss or dilution of the constitutional rights to which the members of NOE are currently entitled, including but not limited to their entitlements and obligations as policyholders.
- 2.2 I summarise below the key aspects of the Schemes, the aspects of the Schemes that I considered, and the conclusions that I reached in respect of those aspects.
- 2.3 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 the Jersey Court hearing to sanction the Jersey 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

- 2.4 Under the Scheme, the Transferring Business and the Transferring Assets will be transferred from SMI to NOE. Under the Jersey Scheme, the Transferring Business that was written in Jersey, together with appropriate supporting assets, will be transferred from SMI to NOE.
- 2.5 SMI is a wholly owned subsidiary of NOE. The Transferring Business, net of the benefit of any attaching reinsurance, is already partially reinsured by NOE under a quota share arrangement. Moreover, NOE has undertaken to guarantee payment of all of SMI's obligations to its policyholders, so as to ensure that they are promptly and adequately discharged in circumstances where SMI does not or is unable to meet those obligations.
- 2.6 The Schemes are intended to transfer to NOE all assets and liabilities remaining within SMI as at the Effective Date, subject to SMI maintaining sufficient capital to satisfy regulatory requirements. Once SMI has discharged or otherwise transferred all of its obligations in respect of the Residual Policies (insofar as there are any), the North Group intends to apply to the PRA for the cancellation of SMI's permissions and the de-authorisation of SMI, after which SMI will be wound up and its remaining capital will be released to NOE.

Motivation for the Scheme

- 2.7 The North Group wishes to optimise its structure in order to achieve its long term strategic objectives of maintaining a sustainable and technically profitable business model for its fixed premium, non-member business. To achieve this, the North Group has developed a strategic plan, part of which is to consolidate the current and future business (excluding non-UK EEA business) of SMI and NOE into a single entity. It believes that this will result in more efficient use of capital within the North Group and considerable cost savings in relation to corporate governance, auditing, compliance, management and other costs that are currently duplicated within NOE and SMI as separate legal entities.

Policyholders Affected

- 2.8 I have considered the effects of the Scheme on the following groups of policyholders:
- the Transferring Policyholders (including, specifically, those policyholders of SMI's Jersey Business);
 - current policyholders of SMI whose policies, for whatever reason, will not be transferred under the Scheme; and
 - the current policyholders of NOE.

Administration

- 2.9 The North Group has established a wholly owned group employee holding company, NGSL. Save for some staff in NOE's Greek office, NGSL employees currently meet all of the staffing requirements of SMI and NOE. As such, all policy administration and servicing for SMI and NOE is performed by NGSL employees, in accordance with North Group policies and the management direction of, respectively, SMI and NOE. While the management direction for policy administration and servicing of the Transferring Business will be provided, post-Scheme, by NOE rather than by SMI, it will be subject to the same North Group administration policies as it was pre-Scheme. Moreover, it will be performed by the same NGSL employees as it currently is. There will be no migration of data from one administration system to another because NGSL will continue to use the existing IT systems (I note that there is an ongoing programme to replace certain legacy systems but that is unaffected by the Schemes).

THE IMPACT OF THE SCHEMES UPON THE TRANSFERRING POLICYHOLDERS

- 2.10 I am satisfied that the proposed Schemes do 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 20 February 2019 (and subsequently where available);
 - the excess assets of the Companies as at 20 February 2019 (and subsequently where available);
 - the risk exposures in the Companies and the impact that the Schemes might have on those; and
 - the standards of policy servicing in each of the Companies.
- 2.11 I concluded that:
- the reserves of SMI and of NOE appeared reasonable as at 20 February 2019;
 - there is no reason to think that the reserve strength of SMI or NOE will be impacted by the Schemes;
 - as at 20 February 2019 (and allowing for the release of the capital add-on, authorised shortly afterwards), SMI and NOE are both very well-capitalised companies (I have defined this term in paragraph 6.4, below);
 - had the Scheme being implemented on 20 February 2019, on a pro forma basis⁷ NOE would have remained a very well-capitalised company;
 - the Transferring Policyholders will not be materially adversely affected due to relative differences in the financial strength of NOE post-Schemes to those of SMI pre-Schemes;
 - although the proposed Schemes 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 Schemes are 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 SCHEMES UPON THOSE POLICYHOLDERS REMAINING WITHIN SMI

- 2.12 It is intended that there will be no policyholders remaining within SMI, assuming that the Schemes are approved and operate as expected. However, it is conceivable that it will not be possible for one or more policies within the Transferring Business to be transferred by legal means to NOE and that therefore the holders of any such policies will remain SMI policyholders. It is also possible that the Canada Assumption Reinsurance (as defined in paragraph 5.16, below) will not have been implemented by the Effective Date, so that the SMI business immediately pre-Scheme still includes Canadian policy liabilities. In such an event, those liabilities would not be transferred as part of the Scheme and the holders of those Canadian policies would also remain SMI policyholders. I have concluded that the Scheme would have negligible impact on those policyholders remaining within SMI.
- 2.13 In reaching this conclusion I have noted that:
- any and all policies that remain within SMI post-Effective Date will be fully reinsured by NOE;

⁷ In this context, by "on a pro forma basis" I am referring to the capital adequacy of NOE had the Schemes been approved and become effective as at 20 February 2019.

- solvency capital will be retained within SMI (pending the run-off of any remaining Canadian business, the transfer of the other remaining policies to NOE by other means and the subsequent removal of permissions by the PRA) at a level that (unless the volume of business remaining in SMI were material) will be significantly greater than the gross liabilities of the remaining policies; and
- NOE has undertaken to treat any policies remaining within SMI no less favourably than they would have been had they been transferred as part of the Schemes.

THE IMPACT OF THE SCHEMES UPON THE EXISTING POLICYHOLDERS OF NOE

2.14 I have concluded that the Schemes would not have a materially adverse impact on the existing policyholders of NOE.

2.15 In reaching this conclusion I have noted that:

- the financial strength of NOE is not altered materially by the Schemes and therefore the existing NOE policyholders will see no material difference in the financial strength afforded to them;
- while it is possible to argue that the existing policyholders of NOE would be disadvantaged by the Schemes due to them sharing ranking post-Schemes with the Transferring Policyholders, the likelihood of NOE becoming insolvent pre- or post-Schemes appears remote and, therefore, the existing NOE policyholders will not be materially adversely affected due to relative differences in their rights pre- and post-Schemes in the event of the insolvency of NOE;
- because of the existing Parental Guarantee (as defined in paragraph 4.73, below), existing NOE policyholders are already exposed to the risks within SMI, albeit indirectly, and that exposure is unaffected by the Schemes;
- neither the Scheme nor the Jersey Scheme will have any effect on the rights of existing members of NOE to secure or prevent further changes that could affect their entitlements as policyholders; and
- there will be no change to the policy administration arrangements in respect of the existing NOE business as a result of the Schemes.

THE IMPACT OF THE SCHEMES IN RESPECT OF OTHER MATTERS

2.16 I have considered the likely effects of the Schemes on the reinsurers whose reinsurance contracts cover the Transferring Business. I am satisfied that the Schemes 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-Schemes by the same people, using the same processes, as it had been pre-Schemes, so the magnitude and timing of recoveries claimed against reinsurance contracts relating to the Transferred Business will be unaffected by the Schemes.

2.17 I have been informed that the Schemes are not expected to have any material tax implications that would affect any of the Companies or any of the groups of policyholders identified in paragraph 2.6, above.

2.18 I have been provided with an estimate of the external costs of the Schemes. I consider that the costs of the Schemes will not be such as to jeopardise the security of any of the groups of policyholders.

APPROACH TO COMMUNICATION WITH POLICYHOLDERS

2.19 The Companies' approach to communicating the Schemes to affected policyholders and other interested parties is outlined in paragraphs 5.53-5.63, below.

2.20 I consider the approach being taken in relation to those Transferring Policyholders and reinsurers that SMI intends contacting directly, as well as to those claimants and existing NOE policyholders that NOE intends contacting indirectly, to be reasonable.

- 2.21 SMI does not intend to notify directly any Transferring Policyholders whose policies are more than three years old and who do not have open claims, on the basis that they are unlikely to be materially affected by the Schemes as no further claims are likely to be reported in respect of these policies. Similarly, NOE does not intend notifying holders of its policies in respect of policy years that have been closed, other than those with open claims, on the basis that it is expected that all claims in respect of such years have been notified and no further claims are expected to emerge, so the impact of the Schemes on such policyholders is expected to be slight. There will be no change to the terms and conditions of the contracts of either the Transferring Policyholders or the existing NOE policyholders. The costs of communicating with all SMI and NOE policyholders would be disproportionate to the likely benefits to the affected parties. Accordingly, The Companies will be applying to the Court for appropriate waivers of the requirement for them to notify all of their policyholders.
- 2.22 In addition to direct, written correspondence with the Transferring Policyholders, NOE policyholders, reinsurers of NOE and reinsurers of SMI (as identified in paragraph 5.55, below), 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.
- 2.23 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.
- 2.24 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 regime that operates in the UK.

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, proprietary general insurance companies are taxed on profits achieved at the main rate of corporation tax (currently 19%⁸ for the financial year ending 31 March 2019). Mutual general insurance companies are taxed only on their investment income and, to the extent that they conduct some business not on a mutual basis, on the proceeds of that non-mutualised business.

⁸ 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 businesses⁹ 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 (or micro enterprises¹⁰) 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.

3.12 These outcomes, 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.

3.13 The FCA has supplemented its *Fair Treatment of Customers* document with guidance, published in January 2018, entitled *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)*. This provides the FCA's view on what the combination of Principles for Businesses and detailed rules require respectively of providers and distributors in certain circumstances to treat customers fairly. The RPPD looks particularly to the following Principles:

⁹ 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.

¹⁰ 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.

- Principle 2: A firm must conduct its business with due skill, care and diligence;
- Principle 3: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems;
- Principle 6: A firm must pay due regard to the interests of its customers and treat them fairly; and
- Principle 7: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading.

The Insurers (Reorganisation and Winding-Up) Regulations 2004

- 3.14 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.

The Insurance Distribution Directive

- 3.15 The Insurance Distribution Directive ("IDD") has applied in the UK (and in all other EU Member States) with effect from 1 October 2018. The key requirements of the IDD are:
- Product oversight and governance arrangements aimed at ensuring that customers' interests are taken into consideration throughout the whole life cycle of an insurance product;
 - Transparency of inducement schemes to ensure respect of customers' interests;
 - The insurance undertaking (or insurance intermediary) providing advice to a customer is responsible for the assessment as to whether the insurance product(s) is/are suitable and appropriate, having regard to the customer's profile; and
 - A conflict of interest policy to facilitate customers' understanding of an insurance undertaking's actions taken on their behalf.
- 3.16 Business conducted via an EU branch is subject to the conduct of business regulations, including consumer protection rules, of the host country of each respective branch. The regulator in the country hosting each branch oversees the compliance of that branch with its insurance laws and regulations, implementing, if appropriate, the relevant EU Directives.

SOLVENCY CAPITAL FRAMEWORK (SOLVENCY II)

- 3.17 The regulatory solvency reporting framework for (re)insurers regulated within the EU, which is commonly referred to as Solvency II, introduced, with effect from 1 January 2016 and consistently across the EU, solvency requirements that reflect the risks that individual (re)insurers actually face.
- 3.18 Under Solvency II, EU (re)insurers are required to adhere to a set of risk-based capital requirements, some of the results of which are shared with the public.
- 3.19 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.
- 3.20 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.

3.21 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. In this Report I denote technical provisions under Solvency II as "TPs".

3.22 TPs 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 be 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 regulation¹¹).

3.23 TPs in respect of claims required under Solvency II differ from the GAAP/IFRS claims reserves in several ways including the following:

- The TPs contain no element of conservatism above a best estimate that may be held in the undiscounted GAAP reserves;
- The TPs 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 TPs include a discount to account for the time value of money in the future cashflows; and
- The TPs include a risk margin.

I have set out the differences and their balance sheet implications in Appendix I.

3.24 The SCR under Solvency II is the amount of capital required to ensure continued solvency over a one-year time frame 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 sub-divided 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.

3.25 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 time-frame (compared to 99.5% for the SCR). The MCR is calculated as a linear function of the TPs 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).

¹¹ Commission Delegated Regulation (EU) 2015/35 dated 10 October 2014.

- 3.26 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.

Brexit

- 3.27 Following the UK Referendum on Continuing EU Membership in June 2016, the UK Government started the process by which the UK would leave the EU (commonly referred to as "Brexit"). The UK Parliament finally ratified the Withdrawal Agreement Bill on 22 January 2020 and the UK's withdrawal from the EU took place late on 31 January 2020.
- 3.28 Although the UK has now formally left the EU, there will be a transition period that will last until 31 December 2020, during which period the existing trading relationships will continue unaltered and the future relationship between the UK and the EU will be negotiated. This transition period may be extended to either 31 December 2021 or 31 December 2022, subject to the mutual agreement of the EU and UK, that agreement to be reached by 1 July 2020.
- 3.29 I consider some of the other possible impacts of Brexit as they might affect the Schemes 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 design, structuring and development of Solvency II;
 - The costs for the UK 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; and
 - 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.
- 3.30 I further note that, on 19 October 2019, the UK and EU agreed a Political Declaration setting out the framework for their future relationship. The declaration indicated that they expect arrangements for financial services to be included within the scope of a future trade deal, that this would include close cooperation on regulatory and supervisory matters, and that an assessment of the equivalence of each other's regulatory and supervisory regimes would be completed before the end of June 2020.
- 3.31 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.

- 3.32 It is possible that the negotiations between the UK and EU regarding the terms of Brexit might 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 the UK formally exits the EU. However, most insurers currently operating across UK/EEA borders have made contingency plans in case the existing passporting arrangements are discontinued promptly on Brexit. Some that are UK based are establishing, or have established, 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 from the UK-based entity. 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.

4. BACKGROUND REGARDING THE ENTITIES CONCERNED IN THE SCHEMES

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 Schemes.

NOE

Background

4.2 NOE is registered in England and Wales as a company limited by guarantee (registered number 00505456) under the Companies Act 1948, having previously been registered (between 17 February 1886 and 13 March 1952) as an unlimited company. It has no share capital.

4.3 NOE's primary business is the provision on a mutual basis (see below) of third-party liability or "protection and indemnity" ("P&I") insurance to ship owners. In this context, "protection" generally means cover for people and ships, whereas "indemnity" generally means cover for cargo. NOE is authorised to write the following classes of business in the UK: 1 (Accident), 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), 15 (Suretyship), 16 (Miscellaneous Financial Loss), and 17 (Legal Expenses). As a mutual organisation, NOE does not seek to make distributable profits from its operations.

4.4 As well as writing business in the UK, NOE:

- Is also authorised (until the conclusion of the transition period) to effect and carry out general insurance contracts in the following countries under EEA Passport Rights: Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, Romania, Slovenia, Spain and Sweden;
- has branch offices through which it conducts insurance business in Australia, New Zealand, Singapore and Japan (the branches in Australia and New Zealand were initially set up to receive the business of equivalent branches of SMI, those transfers being effected in the year ending 20 February 2019);
- has offices in Greece and Hong Kong, which provide local claims handling and loss adjustment services; and
- operates as a surplus lines insurer in the USA, having obtained appropriate accreditation from the International Insurers Department ("IID") of the National Association of Insurance Commissioners ("NAIC").

4.5 NOE has not written any business under Jersey law. However, as at the time of drafting this Report, it is in the process of applying for a Category A insurance licence in Jersey. It anticipates its application being approved ahead of the Effective Date of the Jersey Scheme.

4.6 NOE is a member of the International Group¹².

4.7 NOE is the parent company of the North Group, the other members of the North Group comprising the direct and indirect subsidiaries of NOE (including SMI).

4.8 NOE's financial year runs 20 February - 20 February. Its insurance policies are written with reference to a fixed policy year, which commences at noon GMT on 20 February each year.

¹² I note that the International Group is chaired by a senior manager of one of its thirteen member clubs, elected on a three year rotation, and that the current Group Chairman is Paul Jennings, Chief Executive Officer of NOE, who was elected in November 2018.

Mutuality

- 4.9 NOE operates predominantly upon a mutual model of business whereby those persons that enter ships for insurance with NOE (other than the category of policyholders described in paragraph 4.11, below) are automatically appointed as members of NOE until such time as their entry ceases or is terminated. As such, the members of NOE for each policy year effectively insure each other against the liabilities, losses, costs and expenses for which any of them might become liable to pay in respect of any ship that they have entered for cover during the relevant policy year. The rules of NOE contain provisions that provide it with powers to call upon its members to contribute funds for that purpose.
- 4.10 Policy years remain open until such time as the directors of NOE are satisfied that the claims, expenses and outgoings arising in respect of that policy year have largely been satisfied and that no further contributions are or will be required from the members of that policy year. Upon closure of a policy year, the liability of the members of that policy year to make further contributions in respect of that policy year is expunged. Any surplus that emerges in respect of policy years that have already been closed will be returned to members and/or will be added to NOE's reserves. Any shortfall that emerges in respect of policy years that have already been closed will be met by calls to members in respect of the next most recent open year and/or from the accumulated reserves within NOE's balance sheet. As at the date of this Report, the following Policy Years remain open for NOE: 2017, 2018 and 2019. Of those, Policy Years 2017-2018 are fully earned, whereas 2019 remains partially unearned.
- 4.11 NOE's Articles of Association also permit it to effect and carry out contracts of marine and transit insurance on a fixed premium basis, whereby the policyholder does not become a member of NOE, and NOE does not have the right to seek further premiums from the policyholder in addition to those fixed in the insurance contract. I noted in paragraph 3.8, above, that mutual insurers are taxed on their investment income and, to the extent that they conduct some business not on a mutual basis, on the profits of that non-mutualised business. I have been told by NOE that, historically, the proceeds of its fixed premium business have been deemed by HMRC as being *de minimis* for tax purposes and therefore, to date NOE has been taxed in the UK on its investment income only.

Business Written

- 4.12 The main elements of the business written by NOE are as follows (percentages in brackets are the proportions of total gross premiums written in the year ending 20 February 2019, which totalled US\$305.5 million):
- P&I (88.3%) – this covers the insured's liabilities, costs and expenses arising in respect of cargo, seamen and passengers as well as for third party liabilities in respect of pollution, property damage, wreck removal, salvage and collision;
 - Freight, Demurrage and Defence ("FDD") (6.6%) – this covers the insured's legal costs and expenses incurred in relation to a range of disputes, for example, contractual disputes, that fall outside of the scope of P&I insurance and other forms of shipping insurance;
 - War (0.05%) – this covers insured's losses caused by war and terrorism or as a consequence of a ship being blocked or trapped in an area of conflict;
 - SMI (5.1%) – NOE 60% reinsures SMI's hull and liability business under quota share arrangements.
- 4.13 In addition to the above, NOE also provides reinsurance to a small number of businesses operating in the marine insurance sector.
- 4.14 As noted in paragraph 4.6, above, NOE is a member of the International Group. Under the International Group Agreement, North participates with other members of the International Group for its share of claims arising above a value determined under the agreement.
- 4.15 Fixed premium business accounted for 27.9% of the North Group's premium income for the year ending 20 February 2019 and is projected to increase to around 30% by 2020/21. NOE's strategic objective is for fixed premium business to be maintained at between 30% and 40% of North Group premium income.
- 4.16 NOE has grown significantly, for example between 2002 and 2019¹³:

¹³ The precise tonnage and number of vessels for 2019 is not yet known, as chartered business is entered onto the North Group's databases as and when declared, which typically can take over a year.

- Gross tonnage covered under P&I increased from 39 million to over 200 million and over the same period gross tonnage covered under FDD increased from 25 million to over 150 million;
 - The number of vessels covered increased from 2,500 to over 5,800 under P&I and from 1,088 to over 4,000 under FDD (these numbers indicate that the average sizes of vessels covered have also increased over the period for both P&I and FDD, the number of vessels under P&I having fallen back slightly since 2017 whereas the number under FDD having continued to grow);
 - NOE's shares of both the upper and lower pool layers have both increased significantly. The share of the upper layer peaked in 2012 and since has fallen back a little but has remained fairly stable over the past 5 years. NOE's share of the lower layer peaked in 2014 and has also fallen back a tad, but appears less stable than the share of the upper layer. NOE also took a share of the upper upper layer in 2004, 2013, 2014, 2015 and 2017.
- 4.17 The business written in 2019 covers vessels sailing under 59 different flags and 26 different places of management. This is well spread across the globe, with (by gross premium) 51% coming from the Asia Pacific region, 23% from North America and 18% from the Middle East and India. The remaining amount was from the UK. I note that these numbers were significantly depleted as at 20 February 2019 compared with prior years, as all non-UK EEA business was written or renewed into North EU, not NOE (save for that bound by Knighthood, which continued to be underwritten by NOE). Had the business written into North EU been included, then this would have increased the premiums by over 80% and added another 21 flags and 18 countries. This better reflects the business written historically by NOE and hence the geographical spread of its claims reserves.

Key financial information

- 4.18 As at 20 February 2019, on an IFRS basis, the outstanding claims reserves and provision for unearned premiums ("UPR") were as set out in Figure 4.1, below.¹⁴

FIGURE 4.1 NOE'S CLAIMS RESERVES AS AT 20 FEBRUARY 2019 (US\$'000)

	UPR	Claims Outstanding	Total
Gross	15,299	801,964	817,263
Ceded	-5,556	-800,419	-805,975
Net	9,743	1,545	11,288

- 4.19 The reserves in respect of the outstanding claims, gross of reinsurance, were attributable to the following types of business (percentages in brackets represent the proportion of the total gross outstanding claim amounts):
- P&I (71.3%)
 - FDD (2.8%)
 - International Group pool participation (16.6%)
 - SMI business (both that under the quota share reinsurance and that transferred to NOE prior to 20 February 2019, as referred to in paragraph 4.4, above) (5.4%)
 - Unallocated loss adjustment expenses (2.6%)
 - Other (including separate provision for asbestos-related claims) (1.3%).
- 4.20 NOE management considers that the IFRS booked reserves remain reasonable and in line with its reserving policy. I discuss NOE's reserves in more detail in paragraphs 6.42-6.82, below.
- 4.21 As at 20 February 2019, on an IFRS basis, the total assets and the total liabilities of NOE amounted to US\$1,153.2 million and US\$925.1 million¹⁵ respectively, giving net assets of US\$228.2 million. The net assets represent the capital of the company under IFRS (it should be noted that this is not the same as the own funds available to meet the solvency capital requirements under Solvency II).

¹⁴ Based on NOE Directors' Report 2019, Page 20.

¹⁵ Based on NOE Directors' Report 2019, Page 20.

- 4.22 As at 20 February 2019, on an IFRS basis, NOE held investment assets¹⁶ valued at US\$166.1 million. The majority of this (\$96.9 million) comprised investments in North Group undertakings, but there were also debt securities totalling US\$50.5 million and property, plant and equipment valued as US\$18.6 million.
- 4.23 NOE's financial strength is rated as A (stable) by Standard & Poor's (last updated October 2019), which also rated NOE's capital adequacy as AAA ("extremely strong").

Reinsurance

- 4.24 The Board of NOE has agreed its risk appetite and NOE's reinsurance purchasing strategy is designed to ensure that NOE's appetite for underwriting risk is not exceeded. Most of its external reinsurance is placed on an annual basis (although some elements of the programmes may also include multi-year deals).
- 4.25 NOE reinsurance structure is relatively complex and changes annually (although its general shape has remained constant for at least the last three years). Its arrangements for 2019 are broadly comprised within three programmes:
- the International Group reinsurance programme (covering P&I and oil pollution claims);
 - NOE's own retention/pool aggregation/non poolable placements (mostly stop loss and excess of loss covers, some of which are multi-year and many of which are subject to annual aggregate deductibles, annual aggregate limits, term deductibles and/or term limits); and
 - the 90% quota share reinsurance arrangement with The North of England Mutual Insurance Association (Bermuda) Limited ("NEMIA"), which is a parallel mutual to NOE.
- 4.26 NOE has also purchased "Lock-in Reinsurance" in respect of several policy years. These cover the net position of the P&I and FDD business in aggregate, meaning that other reinsurance covers for those policy years inure to the benefit of the lock-in covers.
- 4.27 In Appendix B, I have included schema illustrating the reinsurance placed in respect of NOE (and SMI) for Policy Year 2019 (not including NOE's quota share arrangement with NEMIA).
- 4.28 Aside from the NEMIA quota share, the covers have been placed with various reinsurers including the following (many reinsurers on this list also cover SMI): Lloyd's (various syndicates), AIG Europe Limited, Hannover Re SE, Allianz Global Corporate & Speciality SE, AXA Corporate Solutions, AXA Catlin, Liberty Mutual, Munich Re, Axis, Partner Re Ltd, and Swiss Re. All of these reinsurers have credit ratings of at least Grade A under Standard & Poor's, or the equivalent as provided by A M Best, Fitch or Moody's.

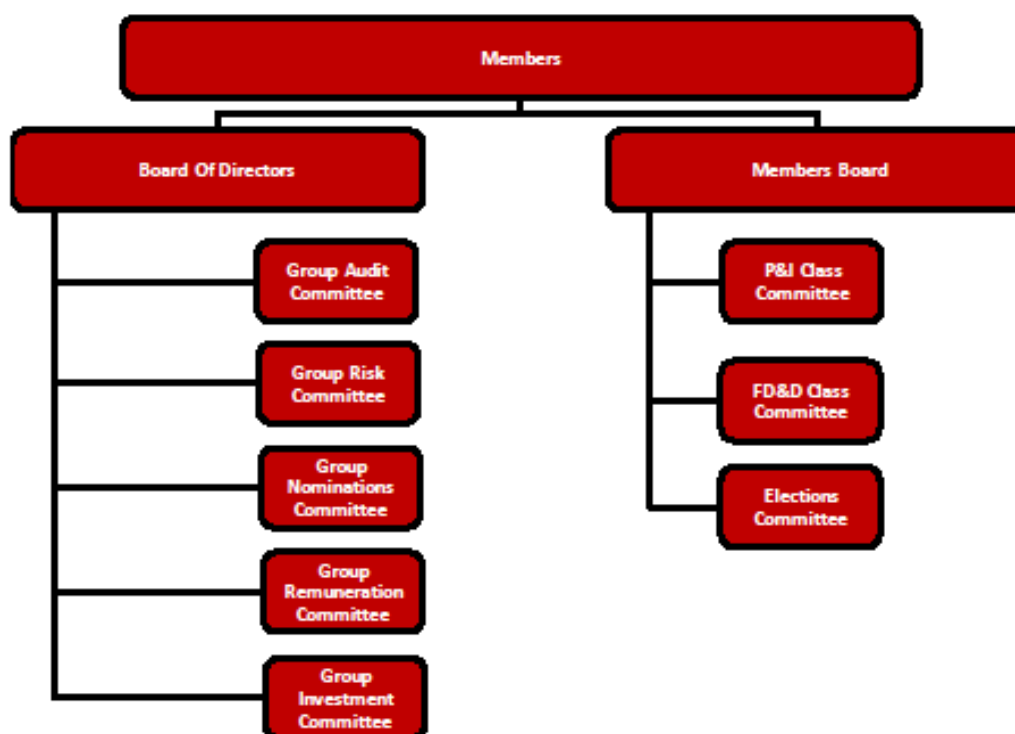
Strategy

- 4.29 NOE's purpose is "*to enable its Members to trade with confidence*" and its vision is to be "*the Club of choice*". NOE has adopted four strategic goals in order to deliver this vision, under the following broad headings:
- Growth and diversity;
 - Innovation;
 - Financial strength; and
 - People and Communities.
- 4.30 Fourteen Key Performance Indicators ("KPIs") have been identified against which NOE's management reports to the Board on a regular basis. These cover all of the strategic goals, and include:
- NOE's target rating by Standard & Poor's;
 - Underwriting growth targets;
 - Maximum combined ratio targets, separately for mutual and non-mutual business;
 - Minimum buffer of capital above the regulatory SCR; and
 - Successful delivery of strategic projects such as the ongoing IT systems upgrades and this Part VII transfer.

¹⁶ Based on NOE Directors' Report 2019, Page 20.

Governance

4.31 The following schematic sets out the governance structure for the North Group and for NOE.



4.32 The Board of Directors of NOE is the principal governing body in the North Group. It has five standing committees, providing additional focus on key areas of governance within the North Group: Audit, Risk, Nominations, Remuneration and Investment.

4.33 The Members Board was established to provide a forum for Members to play an enhanced role in the governance of NOE, outside of General Meetings, and to promote a mutual ethos within the governance structure. It does not perform any statutory or regulated functions.

Retirement benefit schemes

4.34 NOE operates a defined benefit staff pension scheme (the "NOE DB Scheme") that provides benefits based upon final pensionable salary. The assets of the scheme are held separately from those of NOE, being invested with professional managers.

4.35 The NOE DB Scheme was closed to new members on 31 March 2006. On 1 January 2014, additional changes were made that enabled members to remain in the scheme if contributions increased or with a capped pensionable salary. As an alternative, members were able to defer their benefits, at which point they also became eligible to join NOE's (separate) defined contribution scheme. The NOE DB Scheme was closed to future accrual of benefits with effect from 31 January 2018.

4.36 Like NOE, SMI also operates a defined benefit staff pension scheme (the "SMI DB Scheme") that provides benefits based upon final pensionable salary. The SMI DB Scheme was closed to new members on 1 July 2008 and was then closed to future accruals on 31 January 2018. With effect from 1 February 2018, in accordance with a flexible apportionment arrangement¹⁷ between NOE, SMI and the trustees of the SMI DB Scheme, NOE assumed from SMI the responsibilities as the principal employer to the SMI DB Scheme, such that SMI no longer has any residual liabilities relating to the SMI DB Scheme, which instead lie wholly with NOE.

¹⁷ A flexible apportionment arrangement is a standard UK legal device that facilitates the transfer of the pensions liabilities in respect of a defined benefit pension scheme from one employer to another.

- 4.37 The cost of providing benefits under both the NOE DB Scheme and SMI DB Scheme is determined using the projected unit credit method, with actuarial valuations being conducted at each statement of financial position date. Re-measurements, including actuarial gains and losses but excluding net interest, are recognised immediately in the relevant statement of financial position with a corresponding debit or credit to retained earnings through other comprehensive income in the period in which they occur. Re-measurements are not reclassified to income in subsequent periods.
- 4.38 Net interest is calculated by applying the discount rate to the net defined benefit liability or asset. Net interest expense or income plus service costs are recognised in the income statement as incurred.

Risk management strategy

- 4.39 NOE has developed a risk management framework, through which risk management is embedded throughout the North Group, giving visibility to the North Group's overall risk profile and risk tolerance levels. The primary objective of this framework is to protect the North Group's stakeholders from events that hinder the achievement of service and financial performance objectives. A key part of this framework is the ORSA cycle, which is set out below:



- 4.40 The NOE Board has established an ongoing process for identifying, evaluating and managing the significant risks faced by the North Group in accordance with the risk appetite set by the Board.
- 4.41 The remit of the Group Risk Committee is to consider all aspects of high-level risk that may impact on the business and ensure that appropriate systems, controls, processes, policies and procedures are in place to mitigate the effect of such risk. In particular, the Board has delegated to the Group Risk Committee certain key responsibilities within the ORSA framework:
- **Governance:** Oversee the integration of risk management across the North Group and ensure the framework is aligned with its strategic objectives. Review the risk management framework, including its documentation, and related policies and procedures.
 - **Regulatory:** Review the North Group's regulatory position, the outcome from regulatory assessments, regulatory breaches and mitigating actions or responses.
 - **Risk appetite:** Review and make recommendations in respect of risk appetite.
 - **Risk policies:** Review the North Group's risk policies and policies in respect of illegal acts.
 - **Risk identification, measurement, control and reporting:** Oversee the production and maintenance of Risk Registers and assess the appropriateness of risk management controls including controls over illegal acts. Set appropriate risk triggers, monitor and review risk reporting against triggers and review mitigating actions for reporting exceptions. Review risk profiles against the Board's risk appetite.
 - **Investment risk:** Oversight of investment risk including compliance with the Board's agreed appetite for investment risk and ensuring that investment management and decisions are within the framework agreed by the Board for managing investment risk including market and counterparty risks.

- **Capital management plan:** Review the method of assessment of capital requirements and the outputs of those processes.
 - **Stress tests and reverse stress tests:** Review stress tests and reverse stress tests and assess their adequacy and effectiveness in testing the robustness of the North Group's business model.
 - **ORSA assessment:** Review ORSA documentation, assess its adequacy and effectiveness in capturing the ORSA system and its outputs and assess its compliance with regulatory requirements.
- 4.42 Certain management information, produced on a regular, ongoing basis, helps in the identification of both current risks and emerging trends and risks, which then feeds back into risk management activity. The Board considers that managing risk is paramount to the stability of the North Group. To that end, the risk management regime is supported by a risk department, led by the Group Chief Risk Officer ("CRO").
- 4.43 Within the risk management framework, the CRO leads the Risk and Compliance Function for the North Group, which reports to the Group Risk Committee and ultimately to the NOE Board.
- 4.44 The main responsibilities of the Risk and Compliance Function are:
- To identify and assess relevant risks, to determine applicable requirements and to make initial assessment of risk valuation and identify risk limits;
 - To monitor policies and procedures and compliance with them, liaising with other internal control functions to ensure a co-ordinated approach, to monitor risk valuations and risk triggers compared to set limits and stress testing and risk scenario analysis;
 - To advise and to provide training, to the Board, to management and to the staff as and when appropriate or required, to liaise with regulators and to propose risk appetite and tolerance limits; and
 - To report to the Group Risk Committee, and ultimately to the NOE Board, on risk management and compliance activities within the North Group to relevant Board committee.
- 4.45 The CRO also chairs the Enterprise Risk Management Committee, a committee of senior management that has been formed to ensure that sound risk management principles and practices are embedded within the business. The Enterprise Risk Management Committee's core responsibilities are as follows:
- To oversee the establishment, integration and operation of the risk management, compliance and actuarial functions and of the associated policies across the North Group, and to report to the Group Risk Committee thereon;
 - To monitor the alignment of the North Group's risk management framework against the strategic objectives and risk appetite set by the Board of Directors and make recommendations to the Group Risk Committee in that regard;
 - To oversee the production and maintenance of Risk Registers for all relevant entities within the North Group, including the identification and quantification of new and emerging risks and a consolidated Group Risk Register;
 - To monitor regular risk reporting and considering appropriate reporting triggers, reviewing exceptions that arise and monitoring actions proposed to address exceptions;
 - To undertake a programme of risk reporting as agreed with the Risk Committee to include a half yearly assessment comprising independent calculation of NOE's risk profile and position against risk reporting triggers and risk owner assessments;
 - To review regulatory breaches within the North Group and consider what amended or additional controls are required to minimise the risk of recurrence;
 - To consider ORSAs, which cover all North Group entities and which meet regulatory requirements in all relevant jurisdictions;
 - To oversee and review regular stress tests and reverse stress tests that benchmark the North Group's capital assessments, identify scenarios or events that pose a risk to the North Group or one of its entities and recommend actions to be taken to mitigate those risks;
 - To receive regular reports from compliance monitoring activities and determine any actions arising; and
 - To consider any matters that may be referred to it by the Group Risk Committee and to report back thereon.

Risks and Risk Appetite

- 4.46 The NOE Board sets the risk appetite of the North Group, which is documented in a risk appetite statement. The statement is a qualitative and quantitative articulation of the tolerance levels for risk that the North Group is prepared to accept in the execution of its strategic and businesses objectives and provides the link between the Board's strategy and the risk profile, risk register and reporting triggers. The risk appetite statement is a dynamic document, which changes from time-to-time to reflect any amendments that the Board considers appropriate.
- 4.47 The boards of individual members of the North Group reset the risk appetite statements for their own entities annually. However, these are then reviewed for continuing appropriateness within the North Group at each meeting of the Group Risk Committee.
- 4.48 The risk appetite of the North Group is set by the Board, based on the strategic objectives of the business, and the resulting KPIs are cascaded throughout the composite parts of the North Group into the various functions through appropriate systems, controls, policies and processes. The performance of management and staff is measured by reference to these KPIs and is intended to ensure that these principles apply throughout the North Group, regardless of job role.

Insurance Risk

- 4.49 This is a key risk for any insurer, particularly for one such as NOE that operates on a mutual business model.
- 4.50 The objective of NOE's management of insurance risk is to achieve a breakeven technical result and to ensure that the carrying amounts of the insurance liabilities are not exceeded by the actual experience of claims development. NOE manages insurance risk through its underwriting strategy, proactive claims handling, regular review of outstanding claims liabilities, and appropriate reinsurance arrangements.
- 4.51 NOE has a specialised claims department dealing with the mitigation of risks surrounding known claims. Claims are reviewed individually at least bi-annually and adjusted to reflect the latest information on the underlying facts, current law, jurisdiction, contractual terms and conditions, and other factors.
- 4.52 As mentioned above, in paragraphs 4.24-4.28, NOE has secured a comprehensive reinsurance programme (both currently and, as far as I am aware, historically). NOE's reinsurance strategy encompasses two principal areas of claims: claims falling to the International Group Pooling Agreement; and claims not falling to the International Group Pooling Agreement and which are retained by NOE. NOE also partially mitigates its residual insurance risks through its 90% quota share arrangement with NEMIA. In Appendix B, I have summarised the reinsurance programme for Policy Year 2019; the programmes for other years differ from this, depending on the business written and the availability and relative cost effectiveness of reinsurance covers in each of those policy years, but the reinsurance strategy has remained unchanged for several years.

Liquidity risk

- 4.53 Liquidity risk is the risk that cash may not be available to pay obligations when due at a reasonable cost. NOE manages liquidity risk by maintaining adequate reserves and banking facilities and ensuring that the spread of investments across short, medium and long-term funds will enable any short-term funding requirements to be met. The liquidity is monitored continuously by review of actual and forecast cash flows.

Investment risk

- 4.54 NOE manages its investment funds in accordance with an investment framework set out in the Statement of Investment Principles, which is approved by the NOE Board. The framework determines investment policy and the management of investment risk and is reviewed on a regular basis. The detailed consideration of investment strategy is the responsibility of the Group Investment Committee. Investment management is outsourced to professional investment managers.

- 4.55 Should a new investment manager appointment be appropriate or otherwise required, prospective investment managers are interviewed and, if suitable, proposed by the Group Risk Committee and approved for appointment by the NOE Board.¹⁸ The performance of the investment managers against their respective benchmark is monitored on a monthly basis and there is a quarterly review of performance and measurement of portfolio risk by an independent consultant.
- 4.56 The asset class allocation policy is aligned so as to match the liabilities faced by NOE. The current asset allocation is 100% in fixed income and cash assets. The known claims liabilities facing NOE are matched against fixed income assets, representing secure and highly liquid assets known to preserve capital and which, if called upon, could be realised very quickly to settle liabilities.
- 4.57 The most important components of investment risk are market risk (including interest rate risk), currency risk and credit risk, which I discuss below.

Market Risk

- 4.58 Market risk is the risk that, because of market movements, a firm might be exposed to fluctuations in the value of its assets, the amount of its liabilities, or the income from its assets. Sources of general market risk include movements in interest rates, equities, exchange rates and real estate prices. It is important to note that none of these sources of risk is independent of the others. NOE manages its market risk through diversification of allocation to asset classes and through restricting the concentration of investment into any one asset.

Currency Risk

- 4.59 NOE operates internationally and its exposures to foreign exchange risk arise primarily with respect to the US Dollar and, to a lesser extent, UK Sterling and the Euro (I note, from a North Group perspective, that SMI is less exposed than NOE to US Dollar or Euro business, but does have exposure to other currencies). One of the standards in the North Group's Statement of Investment Principles is that assets and liabilities should be matched by currency type. The enforcement of that policy is through the specific investment guidelines under which the investment managers operate. Asset/liability currency management is executed in the active global bond fund with assets held to match liabilities in the required individual currency proportions. The bond managers who manage discretionary portfolios are allowed to deviate from the neutral position, but only to a maximum as allowed by specific investment guidelines and amended from time to time.
- 4.60 I note that NOE holds no Euro-denominated assets. The majority of its funds are invested in Sterling-denominated assets, to hedge the currency risk in the NOE DB Scheme and in the SMI DB Scheme.

Credit risk

- 4.61 Credit risk is the risk that a counterparty will be unable to pay amounts in full when due. NOE is exposed to credit risk in four primary ways:
- **Investment related counterparty risk:** NOE's investment guidelines allow up to 50% of the GBP portfolio to be invested in investment grade corporate credit; no restrictions are placed on the exposure of the portfolios to US/UK Government debt issues. Up to 30% of the GBP bond portfolio can be invested in securities rated BBB/Baa by Standard & Poor's or Moody's with the balance in securities rated A or better. The GBP portfolio may not hold more than 1.5% of any single issue rated BBB/Baa by Standard & Poor's or Moody's or more than 3% of any single issue rated A or AA/Aa by Standard & Poor's or Moody's. A 5% single issuer limit applies to issues of US agency debt, government sponsored enterprises and sovereign/sub-sovereign debt (rated AAA/Aaa by S&P or Moody's). There is no issuer limit applicable to US/UK Government debt issues.

¹⁸ At the date of this Report, a third party had provided draft investment management agreements for NOE and for North EU, which were then being reviewed. Assuming that NOE and North EU approve and implement those agreements, under the terms of the agreements responsibility for selecting investment managers will pass to the third party.

- **Reinsurer's share of insurance liabilities:** The creditworthiness of reinsurers is considered on an ongoing basis by reviewing their financial strength prior to finalisation of any contract. NOE's policy requires that no more than 2% of reinsurance is rated lower than A with Standard & Poor's or equivalent at inception and, for existing reinsurance, credit ratings should be no worse than 80% A rated, 18% B rated and 2% other. As at 20 February 2019, 96% of the reinsurance asset on the balance sheet was rated A or above.
- **Amounts due from NOE's Members:** A Member shall cease to be insured by NOE in respect of any and all ships entered by on behalf that Member (or in a fleet entry in which any one or all of the Member's ships are entered) if that Member fails to pay when due and when demanded by NOE any sum due from the Member to NOE. If a Member has ceased to be insured by NOE through failure to pay any sum due to NOE, NOE is not liable for any claims under the Rules, whether the incident giving rise to such claim occurred before or after the cessation of insurance. Under the Rules, NOE shall be entitled to, and the Member grants, a lien on the entered ship in respect of any amount whatsoever owed by the Member to NOE.
- **Amounts due from insurance intermediaries:** As agents for the Members the rules applying above in respect of amounts due from Members apply to amounts due from insurance intermediaries. With regard to amounts due under contracts of reinsurance ceded, NOE employs insurance intermediaries that are subject to the regulation of and approved by the FCA in the UK. As such, insurance intermediaries are required to operate client trust accounts to ring-fence the amounts held on their clients' behalf.

Operational risk

4.62 Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. In particular, this includes the risk of business interruption, of compliance or regulatory breaches, or of poor service delivery, any of which could result in damage to NOE's reputation and could adversely affect its ability to meet its stated objectives. To help manage this risk NOE has in place the following processes:

- Regular review of service delivery standards, including the prompt review of the causes of shortfalls against minimum standards;
- A dedicated compliance team;
- Detailed business continuity planning and regular testing of the recovery plans;
- Information security assessments, including gap analyses and roll-out of updated policies and procedures;
- A dedicated human resources team ensuring appropriate monitoring of recruitment and staff performance;
- Monthly monitoring of financial results and comparison of those with budget and recent forecasts; and
- Regular monitoring of and interaction with all branches and subsidiaries.

Pension scheme risk

4.63 NOE is exposed to changes in the valuation of assets and liabilities relating to the NOE DB Scheme (and also the equivalent scheme for SMI – see paragraph 4.102, below). NOE monitors the key drivers of the value of those assets and liabilities and includes the NOE DB Scheme (and the SMI equivalent) within its modelling of the business of the company.

The International Group

4.64 I note that NOE's membership of the International Group creates its own risks. The mutual nature of the arrangement means that NOE shares liability for losses incurred by other members of the International Group that penetrate the layers of the pool. It would also be exposed were the International Group, for any reason, to be dissolved. I have been told by the North Group that, as at the last date on which accounts were prepared, NOE was in credit to the pool and so the immediate impact on NOE's balance of a dissolution of the International Group, all other things being equal, is likely to be slightly positive. However, the members of the International Group, including NOE, would likely struggle to obtain replacement covers in the commercial market without paying a significant premium.

Capital Policy

- 4.65 The North Group operates a capital management plan that relates to both global operations and all branches and offices, to ensure that regulatory capital minima, supervisory targets and the North Group's own internal target are met at all times. Capital is monitored by management, the NOE Board and the Group Risk Committee, who all look closely at actual and projected coverage across a number of jurisdictions. In the UK, this includes meeting the capital requirements of the PRA.
- 4.66 As part of its risk management and reporting framework, the NOE Board intends that NOE's Solvency II regulatory capital is maintained at a level at least 120% of that of the SCR (see paragraph 4.30, above).
- 4.67 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 20 February 2019, NOE's solvency capital requirements and the eligible own funds available within NOE to meet those requirements were as set out in Figure 4.2, below¹⁹. As can be seen, as at 20 February 2019, NOE comfortably complied with its strategic objective regarding its SCR Capital Cover Ratio.

FIGURE 4.2 NOE'S AVAILABLE ASSETS AND SOLVENCY REQUIREMENTS AS AT 20 FEBRUARY 2019 (US\$'000)

	MCR	SCR
Eligible Own Funds	205,476	274,776
Solvency Requirement	37,838	151,354
Capital Cover Ratio	543%	182%

Conduct Risk policy

- 4.68 As noted in paragraph 4.29, above, one of the North Group's objectives is "*to provide the highest level of personable, professional and cost effective service to all North Group Members and clients*". This is the basis for its Conduct Risk policy. Key objectives under this policy are:
- No members or clients are lost as a result of poor service levels;
 - Service levels are maintained at a level as good, if not better, than those of other P&I clubs;
 - Member satisfaction with service levels is maintained or improved over time; and
 - No complaints received that relate to NOE and are designated category 3 (severity) or category 4 (service, reputation and member impact) remain unresolved after 6 months.
- 4.69 The North Group undertakes a three yearly member and broker survey, which consists of a qualitative in-depth survey of a sample of key members and brokers and a quantitative online survey of all members. This enables it to evaluate any perceived changes to service ethos and identify any emerging issues or concerns.

Group Complaints handling

- 4.70 The North Group has in place a complaints handling framework. A group register is maintained, in which all complaints and expressions of dissatisfaction are recorded. Complaints are monitored through the management and Board reporting detailed below:
- Monthly reporting to the senior operations team to confirm whether the complaints target (no complaints of category 3 severity or category 4 member impact have been received within the last 12 months that remain unresolved for more than six months) has been met;
 - Quarterly risk reporting to the Group Risk and Compliance Function, as part of the assessment of whether the service risk trigger has been breached;
 - Escalation of any risk trigger breaches (including service risk evidenced by a material increase in complaints or expressions of dissatisfaction) to the Enterprise Risk Management Committee;
 - Quarterly complaints reporting to the senior operations team; and
 - Complaints reporting to each meeting of the Group Risk Committee with escalation to the Board as appropriate.

¹⁹ These figures were taken from QRT S.23.01.01, shown in the solo Solvency and Financial Condition Report for NOE as at 20 February 2019.

- 4.71 I have seen evidence of the reporting of complaints and KPIs as set out above, which appears to be in line with the stated policy. I have not seen evidence of risk trigger breaches being escalated as I am unaware that any such breaches have occurred. I have, however, been provided with documentary evidence of how the North Group responded 2-3 years ago to a particular emerging service issue. I am not at liberty to disclose details of the issue, but I note that the matter was investigated by the relevant departments, the cause was established, and corrective action was taken in what seemed to me to be a timely manner. This appeared to address the issue. While it was not a substantial issue that was being addressed, I believe it showed that the procedures in place to support the complaints policy are effective.
- 4.72 I understand that the complaints policy and procedures are reviewed annually, and are also updated on an ad hoc basis if and when any applicable regulatory changes are introduced.

Parental Guarantee

- 4.73 As part of the demutualisation of SMI and in accordance with a deed signed on 28 February 2014 (the "Parental Guarantee"), NOE agreed:
- To be ultimately responsible for the liabilities of SMI, which includes ensuring that SMI is sufficiently and prudently capitalised to enable it to meet applicable regulatory capital requirements; and
 - To provide protection to guarantee payment of all of SMI's obligations to its policyholders so as to ensure that they are promptly and adequately discharged in circumstances where SMI does not or is unable to do so.
- 4.74 The obligations of NOE under the Parental Guarantee rank *pari passu* with NOE's own policyholder obligations. According to the Parental Guarantee, any shortfall in the funding of SMI's liabilities would ultimately be met from the surplus assets of NOE and, in highly exceptional circumstances where NOE's surplus assets are also insufficient, by way of a supplementary call to NOE's mutual members.
- 4.75 Although not a formal call upon the Parental Guarantee, during 2016 NOE injected US\$25 million into SMI to ensure that SMI could continue to cover fully its SCR.

Current Plans including Brexit

- 4.76 NOE has embarked on a strategic plan that is consistent with its purpose and mission statement, as set out in paragraph 4.29, above. Due to their commercially sensitive nature, I am not at liberty to disclose in this Report details of this plan. However, I note that it appears to me to be consistent with NOE's strategic objectives, as also set out in paragraph 4.29, above.
- 4.77 NOE management recognises that successful execution of this plans depends on maintaining financial discipline, managing a challenging market environment (whereby over-capacity in the shipping markets has led to reduced profitability and a desire by the insureds to manage their costs, including insurance costs, which in turn has made the P&I market highly competitive, driving up combined ratios) and managing underwriting performance, especially the incidence of large claims.
- 4.78 As discussed in paragraph 3.32, above, those UK insurers that currently conduct business elsewhere in the EEA are making, or have made, contingency arrangements in case, post-Brexit, they lose passporting rights to undertake business within the EEA. 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 performed by third country insurers in the absence of local authorisation.
- 4.79 As mentioned in paragraph 1.16, above, to ensure that, post-Brexit, the North Group continues to have access to EEA markets, NOE has established a wholly owned subsidiary insurance company, North EU, in the Republic of Ireland. This is resourced by employees of NGSL. Since 20 February 2019, North EU has underwritten all non-UK EEA insurance business on behalf of the North Group (save for those relating to Knighthood, which continued to be underwritten by NOE), with NOE and SMI continuing to underwrite non-EEA business, as well as running-off existing non-UK EEA business underwritten prior to 20 February 2019.

- 4.80 In due course, NOE anticipates effecting a Part VII transfer to North EU of the non-UK EEA business underwritten by NOE or SMI. That transfer would be subject to a separate scheme. Currently, to simplify workloads within the North Group, NOE anticipates that work will not commence on the transfer to North EU until this Scheme has been approved and effected. The UK Government has announced²⁰ that, to avoid disruption to firms that are already in the process of making a Part VII transfer between UK and non-UK EEA entities, there will be legislation that will introduce a savings provision in relation to insurance business transfer schemes. This will allow up to two years from exit day for parties who have already initiated a transfer of insurance business under the pre-exit process to obtain a Court order sanctioning the transfer. Therefore, work on the transfer to North EU will not be delayed so as to jeopardise the likelihood of it being completed in time to be effective, even if it means that its timetable then overlaps with the work on this Scheme.

SMI

Background

- 4.81 SMI is an insurance company, registered in England and Wales as a company limited by guarantee (registered number 00016432) under the Companies Act 2006. It is a wholly-owned direct subsidiary of NOE. It has no share capital.
- 4.82 SMI :
- Is authorised, until the end of the transition period, to write the following classes of business in the UK: 1 (Accident), 5 (Aircraft), 6 (Ships), 7 (Goods in transit), 8 (Fire and natural forces), 9 (Damage to property), 11 (Aircraft liability), 12 (Liability for ships), 13 (General liability), 15 (Suretyship), 16 (Miscellaneous financial loss) and 17 (Legal expenses).
 - Is authorised to conduct general insurance business in the following countries under EEA Passport Rights: Belgium, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, Spain and Sweden (with effect from 20 February 2019 it no longer writes business in any of these countries; instead, such business is written by North EU);
 - Has a branch office in Canada, which has been in run-off since March 2017;
 - Has a Category A insurance licence to underwrite insurance business in Jersey; and
 - Has reinsurance licences to write reinsurance business in Argentina, Colombia, Ecuador, Honduras, Mexico, Panama, Paraguay, Philippines and Venezuela.
- 4.83 SMI's insurance policies do not have a common inception or renewal date (unlike NOE's insurance policies).
- 4.84 Although SMI's primary regulators are the PRA and FCA, its markets and structure currently require it to meet regulatory capital requirements in two jurisdictions (UK and Canada).

Business Written

- 4.85 SMI provides insurance products for fishing and marine craft, covering primarily risks of loss or damage to the hull and machinery of vessels, and for aquaculture business. SMI also provides P&I insurance to protect an owner's interests against claims from third parties and other associated expenses, as well as personal accident policies for fishing vessels and other small craft. SMI's aquaculture insurance business provides cover for stock, equipment, vessels and support craft used in the farming of fish and other aquatic organisms.
- 4.86 SMI's business is written directly, or sourced through brokers. Historically, it also wrote business through three (now terminated) binding authority arrangements, with:
- Harlock Murray Underwriting Limited ("HMU"), a wholly owned subsidiary of SMI based in Canada;
 - Knighthood Corporate Assurance Services plc, a UK based insurance broker, which was formerly a wholly owned subsidiary of SMI; and
 - Yachtinsure Limited, which acted as an Appointed Representative of International Risk Solutions Ltd., a UK based intermediary.

²⁰ In a document entitled "The Financial Services and Markets Act 2000 (Amendment) (EU Exit) Regulations 2019: explanatory information".

4.87 Gross premiums written in the year ending 20 February 2019 totalled US\$43.2 million²¹. Of this, US\$27.6 million was ceded to reinsurers, leaving net premiums written in the year ending 20 February 2019 totalling US\$15.7 million.

4.88 As discussed in paragraph 1.11, above, following its acquisition by NOE, SMI has just a single member (which is NOE). All holders of SMI policies written prior to its acquisition, who were members of SMI prior to its acquisition, are, along with all holders of policies written since the acquisition, fixed premium, non-member policyholders of SMI.

Key financial information

4.89 As at 20 February 2019, on an IFRS basis, the reserves²² within SMI were as set out in Figure 4.3, below.

FIGURE 4.3 SMI'S CLAIMS RESERVES AS AT 20 FEBRUARY 2019 (US\$'000)

	UPR	Claims Outstanding	Total
Gross	15,806	57,057	72,863
Ceded	-10,567	-39,553	-50,120
Net	5,239	17,504	22,743

4.90 In Figure 4.4 and Figure 4.5, below, I show the outstanding claims reserves as at 20 February 2019, split by cover type and then by geography²³:

FIGURE 4.4 BREAKDOWN BY COVER TYPE OF SMI'S PROVISION FOR OUTSTANDING CLAIMS AS AT 20 FEBRUARY 2019 (US\$'000)

	Marine	Aquaculture
Claims Outstanding	44,169	12,888
Ceded Claims Outstanding	-28,109	-11,444
Net Claims Outstanding	16,060	1,444
Claims Outstanding	77%	23%
Ceded Claims Outstanding	71%	29%
Net Claims Outstanding	92%	8%

FIGURE 4.5 BREAKDOWN BY GEOGRAPHY OF SMI'S PROVISION FOR OUTSTANDING CLAIMS AS AT 20 FEBRUARY 2019 (US\$'000)

	Gross	Reinsurance	Net
TOTAL	57,057	-39,553	17,504
UK	14,588	-8,976	5,612
Non-UK EEA	14,871	-10,571	4,300
North America	13,983	-12,057	1,926
Australasia	695	-428	267
Rest of the world	12,920	-7,521	5,399
TOTAL	100%	100%	100%
UK	26%	23%	32%
Non-UK EEA	26%	27%	25%
North America	25%	30%	11%
Australasia	1%	1%	2%
Rest of the world	23%	19%	31%

4.91 SMI management considers that the IFRS booked reserves remain reasonable and comply with SMI's reserving policy. I discuss SMI's reserves in more detail in paragraphs 6.5-6.35, below.

²¹ Based on Directors' Report, Strategic Report and Financial Statements 2019, Page 14.

²² Based on Directors' Report, Strategic Report and Financial Statements 2019, Page 13.

²³ Based on Directors' Report, Strategic Report and Financial Statements 2019, Page 28.

- 4.92 As at 20 February 2019, on an IFRS basis, the total assets and the total liabilities of SMI amounted to US\$141.9 million and US\$87.2 million²⁴ respectively, giving net assets of US\$54.7 million. The net assets represent the capital of the company under IFRS (it should be noted that this is not the same as the own funds available to meet the solvency capital requirements under Solvency II).
- 4.93 As at 20 February 2019, on an IFRS basis, SMI held investment assets²⁵ valued at US\$44.0 million. The largest share of this (\$38.3 million) comprised debt securities, but there were also investments totalling US\$5.7 million in other North Group undertakings.
- 4.94 SMI's financial strength is rated as A (stable) by Standard & Poor's.

Jersey business

- 4.95 As at 20 February 2019, there were four outstanding claim relating to SMI's Jersey Business, with case estimate totalling US\$37,500. This represents 0.08% of the total case estimates for SMI as at 20 February 2019. Were the gross reserve for claims incurred but not reported ("IBNR reserve") to be hypothecated between the various parts of SMI's business then I have been told by the North Group that a small proportion would be hypothecated to SMI's Jersey Business.
- 4.96 In the year ending 20 February 2019, the gross premiums written in respect of SMI's Jersey Business totalled US\$67,510 (spread across 34 policies). This represents 0.16% of the total gross written premium for SMI in the year ending 20 February 2019. Were the gross UPR reserve to be hypothecated between the various parts of SMI's business then I have been told that a small proportion would be hypothecated to SMI's Jersey Business.
- 4.97 On the basis of the above, I consider that the gross reserves attributable in this way to SMI's Jersey Business would be negligible in the context of SMI's overall reserves. I have therefore not considered them specifically in the remainder of the Report.

Reinsurance

- 4.98 SMI's reinsurance programme for 2019-2020 is set out schematically in Appendix B. This shows that NOE 60% reinsures SMI's hull and liability business under quota share arrangements and that SMI is also protected by a combination of Excess of Loss covers and other quota share covers. The names of reinsurers (aside from NOE) that have provided the covers are included within the list set out in paragraph 4.28, above.
- 4.99 In addition to the aforementioned reinsurance arrangements, SMI has a number of outwards reinsurance contracts in respect of risks written within specific jurisdictions or in respect of specific niche business lines
- 4.100 As noted at paragraph 4.73, above, SMI benefits from the Parental Guarantee issued by NOE. The Parental Guarantee covers SMI's payment obligations to policyholders (and its regulatory solvency requirements) and is unconditional, continuing and binding upon NOE. SMI's policyholders are expressly third party beneficiaries of this guarantee.
- 4.101 It is intended that the Parental Guarantee and reinsurance that currently exist between NOE and SMI will remain in place post-Schemes to cover any residual liabilities, but will become largely superfluous as a result of the Schemes.

Retirement benefit scheme

- 4.102 As discussed in paragraph 4.36, above, with effect from 1 February 2018, in accordance with a flexible apportionment arrangement, NOE assumed from SMI the responsibilities as the principal employer to the SMI DB Scheme, such that SMI no longer has any residual liabilities relating to the SMI DB Scheme.

Risk management strategy

- 4.103 The governance of SMI is consistent with the governance structure for the North Group as set out in paragraphs 4.31 onwards, above. Likewise, the risk management strategy of SMI is consistent with that of the North Group.

²⁴ Based on Directors' Report, Strategic Report and Financial Statements 2019, Page 13.

²⁵ Based on Directors' Report, Strategic Report and Financial Statements 2019, Page 13.

- 4.104 The Board of SMI reviews at least annually the risk appetite statement that applies to SMI, to ensure its continuing appropriateness. The SMI risk appetite statement is then reviewed for continuing appropriateness within the North Group by the Group Risk Committee.

Insurance Risk

- 4.105 This is the risk of insurance payments differing from expectations, in magnitude and/or in timing. Like NOE, SMI manages this key risk through its underwriting strategy (promoting a diverse and balanced portfolio), proactive claims handling, regular reviews of its claims reserves, and adequate reinsurance arrangements.
- 4.106 For Policy Year 2019, SMI is reinsured for marine liability claims above US\$2 million, for Marine hull claims above £1 million and for aquaculture claims above £500,000. Moreover, SMI also partially mitigates its residual marine hull and liability risks through its 60% quota share arrangement with NOE. The marine hull and aquaculture reinsurance covers have a 1 January commencement date.

Market Risk

- 4.107 I have discussed the nature of market risk in paragraph 4.58, above, and do not repeat that discussion here. SMI manages its market risk through diversification of allocation to asset classes and through restricting the concentration of investment into any one asset, in accordance with an investment framework set out in the Statement of Investment Principles for the North Group.
- 4.108 SMI operates internationally and its exposures to foreign exchange risk arise primarily with respect to US Dollar, to UK Sterling and to certain other non-Euro currencies. The asset class allocation matches the assets against SMI's technical provisions by currency, as well as by expected maturity.

Credit risk

- 4.109 I have discussed the nature of credit risk in paragraph 4.61, above, and do not repeat that discussion here. SMI is exposed to credit risk in respect of: investment related counterparty risk (managed by compliance with the North Group's investment guidelines); amounts due from insurance intermediaries (managed through the regular monitoring of overdue receivables), and reinsurers' share of insurance liabilities (managed through ensuring that reinsurance is only obtained from reinsurers that satisfy the creditworthiness criteria operated by SMI).

Liquidity risk

- 4.110 I have discussed the nature of liquidity risk in paragraph 4.53, above, and do not repeat that discussion here. SMI manages its liquidity risk by maintaining adequate reserves and banking facilities and ensuring that the spread of investments across short, medium and long-term funds will enable any short-term funding requirements to be met. This is monitored continuously by review of actual and forecast cash-flows, those forecast cash-flows being tested in stressed conditions.

Operational risk

- 4.111 I have discussed the nature of operational risk in paragraph 4.62, above, and do not repeat that discussion here. To help manage this risk SMI has in place the following processes:
- Regular review of service delivery standards, including the prompt review of the causes of shortfalls against minimum standards;
 - A dedicated compliance team;
 - Detailed business continuity planning and regular testing of the recovery plans;
 - Information security assessments, including gap analyses and roll-out of updated policies and procedures;
 - A dedicated human resources team ensuring appropriate monitoring of recruitment and staff performance;
 - Monthly monitoring of financial results and comparison of those with budget and recent forecasts; and
 - Regular monitoring of and interaction with all branches and subsidiaries.

Pension scheme risk

4.112 Following the implementation with effect, from 1 February 2018, of the flexible apportionment arrangement between NOE, SMI and the trustees of the SMI DB Scheme (see paragraph 4.102, above), SMI is no longer exposed to pension scheme risk.

Capital Policy

4.113 SMI operates a capital management plan that reflects both its own standalone situation and its position within the North Group. Capital is monitored by SMI management, the SMI Board and the North Group Risk Committee who all look closely at actual and projected coverage across a number of jurisdictions (in addition to UK capital requirements, SMI currently has to abide by the regulatory requirements in Canada, in respect of its branch).

4.114 As part of its risk management and reporting framework, the SMI Board intends that SMI's Solvency II regulatory capital is maintained at a level at least 130% of that of the SCR (see paragraph 4.30, above).

4.115 As at 20 February 2019, SMI's solvency capital requirements and the eligible own funds available within SMI to meet those requirements were as set out in Figure 4.6, below²⁶. As can be seen, as at 20 February 2019, SMI comfortably complied with its strategic objective regarding its SCR Capital Cover Ratio.

FIGURE 4.6 SMI'S AVAILABLE ASSETS AND SOLVENCY REQUIREMENTS AS AT 20 FEBRUARY 2019 (US\$'000)

	MCR	SCR
Eligible Own Funds	52,329	52,329
Solvency Requirement	7,806	31,223
Capital Cover Ratio	670%	168%

Conduct Risk policy

4.116 I have discussed in paragraph 4.68-4.72, above, the North Group's key objectives and its general approach in respect of conduct risk policy. SMI also has its own Treating Customers Fairly Policy, initially implemented in June 2011 and subsequently reviewed and revised in each of years 2013-2019.

4.117 SMI has identified outcomes and measurements that, based on the size, structure and nature of SMI's business, it considers appropriate in respect of those of the six TCF outcomes identified by the FCA applicable to SMI (for example, as SMI does not provide advice, as defined by the FCA, Outcome 4 is inapplicable). SMI therefore aims to achieve and monitor the following:

- ensuring that the TCF initiative is central to its corporate culture by embedding it into its culture, systems and controls through to Board level;
- embedding relevant policies into its culture through to Board level;
- ensuring that its staff have thorough training on all products on which they advise or sell, understand for whom they are and are not suitable, and are encouraged to challenge product providers where they spot inconsistencies, ambiguities or potential unfairness in the product literature or product features;
- finding ways to encourage non-sales staff to implement TCF in their day to day business activities;
- keeping detailed records of its customer instructions and profile/attitude to risk, and of the advice and options given before, during and after a sale - to help ensure it treats its customers fairly and can deal swiftly and fairly with any complaints that may arise;
- encouraging after sales contact with clients where appropriate to correct or improve on the service already offered;
- ensuring that customer complaints are assessed fairly, promptly and impartially, and in line with FCA deadlines and rules;
- encouraging staff to recommend improvements to service following customer complaints - and monitoring the outcome;
- ensuring that its staff are kept up to date with relevant training in relation to competence, data protection and other matters directly affecting the quality of service offered to its customers;

²⁶ These figures were taken from QRT S.23.01.01, shown in the Solvency and Financial Condition Report for SMI as at 20 February 2019.

- offering regular training in the principle of TCF at all levels of the business;
- regularly monitoring and reporting on all of the above TCF activities as part of the SMI's quarterly statistics and/or management information, in order to assess TCF performance across the business and to recommend changes where appropriate;
- ensuring that TCF values, which are set and communicated by senior management, are supported by all staff within SMI and understood in the same way; and
- maintaining systems to monitor complaints by SMI customers to detect and evaluate breaches of the above objectives. These will be reported to the Board periodically, but not less frequently than annually.

4.118 SMI produces quarterly management information on its TCF performance. I have reviewed the key metrics behind this quarterly information, and these appear likely to me to indicate where customer service is declining or falling short of standards. Reports of findings are then distributed to the Board. Additionally, the effectiveness of the TCF Policy is reviewed by the Board at least annually.

Current Plans including Brexit

4.119 SMI's strategic plan was developed in 2016 and was intended to stabilise and improve its business performance, key elements of which included:

- Withdrawing from areas of business that are unprofitable;
- Developing core areas and then closely monitoring the performance of those areas to ensure that they remain profitable;
- Reducing costs to ensure that the ongoing business remained sustainable (this is one of the drivers for the Schemes); and
- Developing non-risk bearing commercial activities (if appropriate this would be via subsidiaries).

4.120 SMI management recognises that successful execution of these plans depends on maintaining financial discipline, managing a challenging market environment and managing underwriting performance, including achieving ambitious premium targets without compromising on underwriting controls. It feels that it has made good progress in all of these areas since the start of the implementation of the plan.

4.121 SMI has historically written business within the EU but outside the UK on a Freedom of Services basis. With effect from 20 February 2019, such business has no longer been written (or renewed) by SMI, rather it has been written instead by North EU. Were the Schemes not planned to take place then it is possible that, post-Brexit and notwithstanding any transition arrangements, SMI would be unable to service that of its business written within the EU but outside the UK. In such circumstances, I understand that SMI would take action to effect as soon as possible a Part VII transfer of its non-UK EEA business to North EU.

NEMIA

4.122 As noted above, 90% of NOE's business is reinsured to NEMIA under a quota share agreement. As a result, the financial security of NOE's policyholders (including, post-Scheme, the current SMI policyholders) is materially affected by the continuing ability of NEMIA to meet its obligations to NOE under the terms of the quota share reinsurance. Therefore, I consider NEMIA to be among the entities involved in the Scheme.

Background

4.123 NEMIA is registered in Bermuda (registration number 22688). It holds a Class 2 licence under The Insurance Act 1978. It is also subject to the Segregated Account Companies Act 2000, which provides for the creation of legally segregated cells for the conduct of insurance business, and ensures that creditors of a segregated cell have no access to the assets of other segregated cells. Only one cell, The North Cell, has been created within NEMIA.

4.124 As already mentioned, NEMIA reinsures 90% of the P&I and FDD risks of NOE. For the last financial year, the discount was 25% for P&I and 35% for FDD. Following the transfer to NOE of the business of the SMI branches in Australia and New Zealand, NEMIA also reinsures 60% of the P&I and FDD risks of the Australian business and 90% of the P&I and FDD risks of the New Zealand business.

4.125 To date, NEMIA has accepted no other business.

4.126 NEMIA is a parallel mutual to NOE. As such, anyone becoming a member of NOE also becomes a member of NEMIA, such that the membership, and hence the effective ownership, of NOE and NEMIA is identical. However, the boards and management of NEMIA and NOE are completely separate from one another.

Key financial information

4.127 As at 20 February 2019, on a UK GAAP basis, the outstanding claims reserves and provision for UPR were as set out in Figure 4.7, below.²⁷

FIGURE 4.7 NEMIA'S CLAIMS RESERVES AS AT 20 FEBRUARY 2019 (US\$'000)

	UPR	Claims Outstanding	Total
Gross and Net	4,500	532,872	537,372

4.128 NEMIA does not retrocede any of the risks that it has assumed.

4.129 As at 20 February 2019, on a UK GAAP basis, the total assets and the total liabilities of NEMIA amounted to US\$788.0 million and US\$573.2 million²⁸ respectively, giving net assets of US\$214.8 million. The net assets represent the capital of NEMIA under UK GAAP.

4.130 As at 20 February 2019, on a UK GAAP basis, NEMIA held investment assets²⁹ valued at US\$762.7 million. The majority of this (\$647.0 million) comprised holdings of debt securities (rated at least BBB), but there were also equity securities totalling US\$115.8 million.

4.131 NEMIA's financial strength is rated as A (stable) by Standard & Poor's (last updated October 2019).

²⁷ Based on NEMIA's Financial Statements 2019, Page 3.

²⁸ Based on NEMIA's Financial Statements 2019, Page 3.

²⁹ Based on NEMIA's Financial Statements 2019, Page 3.

5. THE PROPOSED SCHEMES

SUMMARY OF THE SCHEMES

- 5.1 In this section of the Report, I 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. I do not describe separately the Jersey Scheme as it is very similar to the Scheme save that the transferring business is just the SMI Jersey Business, not all of the general insurance business underwritten by SMI, and that the Jersey Scheme is conditional on the Scheme being effective.
- 5.2 Assuming that the Court and the Jersey Court approve the Schemes as proposed, the entire insurance business of SMI (the Transferor) will be transferred to NOE (the Transferee) at and with effect from 00.00 hours GMT on the Effective Date (30 June 2020)., This will include, without limitation, all of SMI's assets, liabilities, insurance policies and the outward reinsurance policies in respect of the Transferring Business. As provided for in the Scheme Document, such amount of the Transferring Assets as is necessary to ensure that SMI continues to comply with its capital requirement after the Effective Date, as well as to fund the technical provisions for the Residual Policies (as defined in paragraph 5.33, below), shall be retained by SMI and shall not transfer until the PRA has confirmed in writing to SMI that all SMI's authorisations under Part 4A of FSMA have been cancelled, following which such assets shall be transferred to NOE pursuant to the Scheme Document.
- 5.3 There will be no changes to the terms and conditions of any policy included within the Transferring Business as a result of the Scheme. SMI's rights and obligations under the policies that comprise the Transferring Business will be transferred, without alteration, to NOE. 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 NOE as were available to them against SMI under such policies and will be accountable to NOE for any further or additional premiums or other amounts attributable or referable thereto as and when the same become due and payable.
- 5.4 Any pending or current proceedings or complaints issued or served before the Effective Date by or against SMI in connection with the Transferring Business shall be continued by or against NOE in place of SMI, and SMI 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 SMI will instead be by or against NOE. NOE shall be entitled to all defences, claims, counterclaims and rights of set-off that would have been available to SMI in respect of the Transferring Business.
- 5.5 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 NOE in the place of SMI.
- 5.6 NOE shall indemnify SMI against any loss or expense incurred by SMI, whether before or after the Effective Date, that is attributable to the Transferring Business.
- 5.7 The Transferring Policyholders are currently fixed premium, non-member policyholders of SMI. It is intended that, upon completion of the Scheme, the Transferring Policyholders will become fixed premium, non-member policyholders of NOE.
- 5.8 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 NOE (and not by the Transferring Policyholders).
- 5.9 The terms of the Scheme are governed by English law. The terms of the Jersey Scheme are governed by Jersey law.

MOTIVATION FOR THE SCHEMES

- 5.10 As at the date of the Report, there is (and has been for some time) significant pricing pressure in the P&I market. The relatively benign claims environment and difficult freight markets means that this situation is likely to continue for the foreseeable future. The market for insuring marine and aquaculture risks is also highly competitive with no indication of generalised upwards pressure on premium rating in the short-term. As noted in paragraph 4.29, above, the North Group has developed as its long-term strategic objectives the maintenance of a sustainable and technically profitable business model, and the Schemes are designed to drive cost efficiencies to support this objective.

- 5.11 To that end, the North Group has developed a strategic plan (to which I refer in paragraph 4.76, above), part of which is to consolidate the current and future business of SMI and NOE into a single entity. It believes that this will result in more efficient use of capital within the North Group and considerable savings in relation to corporate governance, auditing, compliance, management and other costs that are currently duplicated within NOE and SMI as separate legal entities. The North Group has estimated that such consolidation will result in annual cost savings of roughly US\$1.5 million, of which the steps that have already been taken (such as the transfer to NOE of the SMI branch businesses in Australia and New Zealand) have already realised about a third of such savings.
- 5.12 As alluded to in paragraph 1.9, above, the restructuring of the North Group comprises several parts, two of which are the Schemes. The other key part of the restructuring concerns that business written within SMI's branch in Canada (see below).
- 5.13 As noted in paragraph 1.16, above, NOE has established in the Republic of Ireland a wholly owned subsidiary insurance company, North EU. At the time of its establishment, the negotiations regarding the terms of Brexit were due to conclude on 29 March 2019, with the UK exiting the EU on that date. North EU was intended as a contingency against the risk that, post-Brexit and through the consequential loss to UK entities of passporting rights into the EU, the North Group would be unable to have access to EEA markets. Therefore, since 20 February 2019, (nearly) all of the North Group's non-UK EEA insurance business has been underwritten by North EU and not by NOE or SMI. NOE and SMI continue to run-off existing non-UK EEA business that inceptioned prior to 20 February 2019 (the "Legacy EEA Business"), under the existing passporting arrangements that will last until the conclusion of the transition period (currently expected to last until 31 December 2020).
- 5.14 In a white paper, dated July 2018 and entitled "*The Future Relationship between the United Kingdom and the European Union*", the UK government made clear its expectation that future arrangements relating to financial services "*will not replicate the EU's passporting regimes*". However, it is still possible that a future UK and EU trade deal will include more limited arrangements that would allow NOE and SMI to continue run-off their Legacy EEA Business from the UK. It is also possible that individual EEA member states (that are places of management for Legacy EEA Business) would introduce domestic legislation that would permit allowing NOE and SMI to continue to the run-off of the relevant contracts within the Legacy EEA Business from the UK. Such legislation could be introduced in the absence of an adequate run-off mechanism being included within a UK/EU trade deal or in the event that the UK and EU are unable to agree a trade deal during the transition period.
- 5.15 In conclusion, it is currently uncertain how best the North Group should structure the run-off of the Legacy EEA Business. One option is to effect a Part VII Transfer of the Legacy EEA Business from SMI and NOE to North EU, and the North Group has informed the PRA of its intention to explore such a path (the "Brexit Part VII"). As the future trade arrangements have been (and remain) unclear, the North Group has decided to defer work on the transfer of the Legacy EEA Business until the Scheme has been concluded. As such, the Brexit Part VII would then be a transfer of business from NOE to North EU, the Scheme having moved to NOE all Legacy EEA Business that hitherto had been within SMI. I note that it would have been possible to wrap the Brexit Part VII together with the Scheme, to effect one such Part VII transfer rather than two. This would have meant that (assuming approval of the various transfers) non-UK EEA SMI business would have moved directly from SMI to North EU, rather than first to NOE and then, as short while later, to North EU. While I believe that a single scheme embracing both the Scheme and the Brexit Part VII would have been practicable, I also recognise the North Group's arguments for keeping the two transfers separate and I consider its conclusions to be reasonable.

SMI's branch in Canada

- 5.16 SMI has a licensed branch office in Canada. This office ceased writing new insurance business on 27 March 2017 and is now in run-off. SMI has agreed in principle to transfer all of its Canadian hull and liability insurance business to a third party insurer by means of an assumption reinsurance transaction (the "Canada Assumption Reinsurance"). The transfer will include all hull and liability insurance liabilities and the quota share reinsurance contracts that expressly inure to the benefit of this business, other than the quota share reinsurance provided by NOE. No business other than hull and liability covers written through SMI's Canadian branch will be included within the Canada Assumption Reinsurance.

- 5.17 Completion of the Canada Assumption Reinsurance transaction will be subject to approval by the Office of the Superintendent of Financial Institutions ("OSFI"), which regulates SMI's branch in Canada. At the date of this Report, SMI and the third party insurer were negotiating the detail of the relevant legal documentation. Therefore, the effective date for the Canada Assumption Reinsurance (the "Canada Effective Date") is currently unknown. It is possible that it will be after the Effective Date of the Schemes.
- 5.18 The Canada Assumption Reinsurance will not novate policies from SMI's branch in Canada to the third party writing the assumption reinsurance agreement. Instead, it will provide holders of hull and liability policies issued by SMI's branch in Canada with a direct right of claim against that third party and will indemnify SMI against any further claims arising against it in respect of such business.
- 5.19 All assets and liabilities of SMI that may exist in respect of its branch in Canada and that are residual to the Canada Assumption Reinsurance would be included under the Scheme with all other SMI liabilities to be transferred to NOE, subject to SMI continuing to satisfy OSFI's financial requirements in respect of its Canada branch (see paragraph 5.21 below). The assets would include the indemnification of SMI by the third party writing the Canada Assumption Reinsurance against any further claims arising in respect of the business covered by the Canada Assumption Reinsurance, which, post-Scheme, would indemnify NOE rather than SMI.
- 5.20 As at 26 January 2020, SMI's Canada branch had five outstanding claims relating to hull and liability policies, with an estimated total value of Can\$341k, gross of reinsurance, and Can\$137k, net of reinsurance. Since 30 September 2019, four policies have been settled and closed, for a gross amount of Can\$0.9 million. It is possible that SMI's hull and liability business within its Canada branch will have fully run-off prior to the Effective Date and/or the Canada Effective Date. If this business were to run-off prior to the Canada Effective Date then the Canada Assumption Reinsurance would no longer have any purpose and therefore would not be enacted.
- 5.21 Subject to certain financial confirmations, after the Effective Date of the Schemes and once the Canada Assumption Reinsurance has become effective or the business that it is intended to cover has fully run-off, OSFI will permit SMI's branch in Canada to cease carrying-on business in Canada, to be de-authorised and to release its Canadian Trust Fund assets. Once this has been completed, SMI will proceed to close its Canadian branch office.
- 5.22 As explained above, the timing of the closure of SMI's Canada branch office is dependent upon a number of factors and thus is uncertain. I have been told by the North Group that it expects the closure to occur prior to the end of the 2020/21 club year (i.e. by 20 February 2021). I consider this to be a reasonable expectation, but note that it could be delayed beyond that date.
- 5.23 I have been provided with a letter from Norton Rose Fulbright Canada LLP ("NRFC") in which it stated that
- it was of the view that the Canada Assumption Reinsurance³⁰ was in an appropriate form to be approved by OSFI;
 - while the Canada Assumption Reinsurance will only transfer to the third party the economic liability relating to those of SMI's obligations covered by the agreement, leaving with SMI the legal liability, OSFI will consider those liabilities to be part of the third party's liabilities post the Canada Effective Date and will require the third party (and not SMI) to hold, in trust in Canada, sufficient and appropriate assets to support those liabilities;
 - it saw no reason why, subject to required factual confirmations to be made by SMI subsequent to both the Effective Date and the Canada Effective Date, OSFI should not approve the release of the residual assets of SMI's Canada branch and its de-authorisation by provincial and federal regulators in Canada; and
 - it also had no reason to believe that the Scheme would not be recognised by the Canadian courts as transferring to NOE any residual liabilities of SMI to its policyholders and/or its rights to enforce the Canada Assumption Reinsurance against the third party insurer that is party to the Canada Assumption Reinsurance.

³⁰ I note that NRFC reviewed and opined upon an earlier version of the proposed Canada Assumption Reinsurance, which involved a different third party. I have been informed by SMI that the agreement on which it is currently negotiating the detail is substantially the same as the earlier version that NRFC reviewed in support of its letter.

- 5.24 I have studied the letter from NRFC. I am not a legal expert but I consider that the arguments supporting the conclusions set out in the letter have been clearly set out and that, in the context of those arguments, the conclusions appear reasonable.
- 5.25 I understand that the North Group intends that the Scheme will proceed even in the event that the Canada Assumption Reinsurance has not been completed as at the Effective Date. In such an event, the hull and liability business of SMI's branch in Canada would be treated as Residual Policies for the purposes of the Scheme and would remain with SMI, pending completion of the Canadian Assumption Reinsurance or the eventual run-off of these policies.

SMI's branch in Alaska

- 5.26 SMI's branch in Alaska has been in run-off since 20 February 2016. All policies of SMI's branch in Alaska have been transferred under an assumption reinsurance agreement from the branch to the head office of SMI, with the exception of those relating to eleven policyholders who exercised a statutory right to opt out of the transfer.
- 5.27 By 8 November 2016, all policies of SMI's branch in Alaska had expired. Typically, claims are notified within six months of the expiry of cover and so it is likely that few, if any, claims are yet to be reported in respect of this business.
- 5.28 As requested by the Alaskan regulator, any further residual liability on the policies that opted out of the assumption reinsurance agreement has been 100% reinsured by NOE, under an indemnity reinsurance agreement, dated 20 December 2017.
- 5.29 With the indemnity reinsurance agreement with NOE in place, the Alaska Division of Insurance has approved the voluntary surrender by SMI of its Certificate of Authority to operate in Alaska. Hence, SMI no longer has a branch operation in the USA.
- 5.30 Any residual assets and liabilities of SMI that may exist in respect of its branch in Alaska would be included under the Scheme with all other SMI liabilities to be transferred to NOE.

US Surplus Lines Trust

- 5.31 Between 30 November 1988 and June 2018, SMI was listed on the NAIC Quarterly Listing of Alien Insurers and operated as a surplus lines insurer in the USA. In order to cease conducting surplus lines business in the USA, SMI effected the transfer of such business to NOE pursuant to an assumption and assignment agreement, dated 5 October 2018 ("Novation Reinsurance"). I have seen a legal opinion that explains that, subject to the consent of US surplus lines policyholders, the Novation Reinsurance means that all liability (in respect of those who consent) is assumed by NOE, and SMI is contractually released from those liabilities. I note that the legal opinion further states that not objecting would be deemed effective consent for these purposes. As I noted in paragraph 5.24, above, I am not a legal expert but, again, I consider that the arguments supporting the opinions have been clearly set out and that, in the context of those arguments, the opinions expressed appear reasonable. SMI has told me that, in February 2018, after the final policies had expired, it wrote to (almost) all of its US surplus lines policyholders who had claims that were then open, seeking their consent to the Novation Reinsurance. SMI has also told me that none of the policyholders contacted notified their objection to the Novation Reinsurance, and that, accordingly, all notified policyholders are deemed to have consented. SMI has since de-registered its surplus lines permission.
- 5.32 I have also been told by SMI that there are nine open claims in relation to US risks where the policyholders did not receive notification of the Novation Reinsurance. Five relate to claims either that had been notified and closed prior to, then reopened after, February 2018, or that were not notified until after February 2018. A further four claims were erroneously omitted from the notification process. Accordingly, the liability in respect of these nine policies currently remains with SMI, and will be included within the Transferring Business.

POLICYHOLDERS AFFECTED

- 5.33 I have considered the effects of the Schemes on the following groups of policyholders:
- the Transferring Policyholders (including those holders of policies written under Jersey law);

- any policyholders of SMI whose policies are not capable of being transferred to NOE by the Schemes for legal reasons (any and all such policies will be considered to be "Residual Policies"); and
- the current policyholders of NOE.

5.34 I do not consider that the policyholders of any other insurance companies are affected by the Schemes.

RESIDUAL POLICIES

- 5.35 On and with effect from the Effective Date, any and all Residual Policies will be fully reinsured by NOE, for no further consideration. The Scheme provides that the liability of NOE on and with effect from the Effective Date shall be such that the rights, benefits and powers provided to holders of Residual Policies shall, to the extent possible, be the same as the rights, benefits and powers which would have been provided to such holders if the Residual Policies had been transferred as part of the Schemes.
- 5.36 Post the Effective Date, any outwards reinsurance contracts that applied to Residual Policies will have been transferred to NOE and, therefore, the Residual Policies will no longer be reinsured under those contracts. Instead, NOE will assume the gross liabilities of the Residual Policies and shall then cede to each reinsurer that is party to such Residual Policies such liabilities (if any) as would have been ceded to those reinsurers had the Residual Policies transferred.
- 5.37 The North Group intends that any Residual Policies relating to the Canadian branch will either be transferred to a third party under the Canada Assumption Reinsurance, whereupon they will cease to be liabilities of SMI, or will continue to be treated as Residual Policies until their run-off. If there are any other Residual Policies post the Effective Date then the Companies shall work towards subsequently transferring each and every Residual Policy to NOE, by novation or other means.
- 5.38 While it is possible that there will be some Residual Policies, none are currently expected (other than those relating to Canadian branch business that would result from the non-completion by the Effective Date of the Canadian Assumption Reinsurance).

POLICY ADMINISTRATION

- 5.39 As discussed in paragraph 1.13, above, the operational management of both SMI and NOE, including all policy administration, claims handling, etc. in respect of the Transferring Business and that of NOE, is currently conducted, under the direction of SMI and NOE, (mostly) by employees of NGSL³¹. This will continue to be the case post-Scheme, save that direction will be provided by NOE only.
- 5.40 As a result, while the Scheme will move accountability for policy administration and servicing from SMI to NOE (albeit with NOE operating in respect of this business as "Sunderland Marine", the name having been trademarked and being retained as a trading name), it is intended and expected that the Transferring Policyholders will experience no difference in the administration and servicing of their policies and claims between the periods before and after the Effective Date, and it is intended that those operations are undertaken pursuant to substantially the same arrangements as currently exist. I note that the corporate governance arrangements of NOE and of SMI, their key systems of governance (risk, compliance, actuarial and internal audit), and their financial and operational reporting arrangements are already materially consistent with one another.
- 5.41 There will be no migration of data across administration systems because, as directed by NOE, NGSL employees will continue to operate the existing SMI IT system for the Transferring Business and for any new business of the type written under the Sunderland Marine trade name.
- 5.42 On and from the Effective Date, NOE shall become the sole data controller of any personal data (as opposed to the joint controller) that relates to the Transferring Business (excluding any Residual Policies). As such, NOE shall owe to the Transferring Policyholders or to any other person the same duties of confidentiality and privacy (whether pursuant to statute or contract) both prior to and from the Effective Date.

³¹ *There are a few exceptions to this. As noted in footnote 5, above, the small team of NOE staff in Greece did not transfer to NGSL but remain with NOE, servicing Greek business. SMI's Canadian business is also not administered by NGSL employees, rather the administration has been outsourced by SMI to HMU. NGSL employees in Australia and New Zealand have been seconded on a full-time basis to NOE where they provide policy administration for NOE's branch in Australia and in New Zealand.*

RETIREMENT BENEFIT SCHEME

- 5.43 As noted in paragraph 4.102, above, the SMI DB Scheme has been closed to new members since 2008, and was closed to future accrual with effect from 31 January 2018. As described in paragraph 4.102, above, NOE has assumed liability for all of SMI's liabilities as statutory employer of the SMI DB Scheme with effect from 1 February 2018, in accordance with a flexible apportionment arrangement. However, it is not currently intended to merge the SMI DB Scheme and the NOE DB Scheme.

COMPENSATION AND COMPLAINTS

- 5.44 The Schemes will have no impact on the eligibility of any policyholder or group of policyholders for compensation under the FSCS. SMI policyholders that are currently eligible to access the FSCS will continue to have access to the FSCS after the Effective Date. As noted in paragraph 3.9, above, the FSCS does not cover marine business. I have been told by NOE that all of its business is categorised as "marine", and hence no NOE policyholder is currently eligible to claim compensation under the FSCS; the current eligibility, or otherwise, of NOE policyholders to access the FSCS will not alter after the Effective Date.
- 5.45 The Schemes will have no effect on the eligibility of any policyholder or group of policyholders to bring complaints to the UK FOS. If, as described in Section 3, above, they are currently able to bring complaints to the FOS, then this will remain the case after the implementation of the Schemes. If they are currently not eligible to complain to the FOS then this will also remain the case after the implementation of the Schemes.

EFFECT OF THE SCHEMES ON THE BALANCE SHEETS AND CAPITAL COVER RATIO OF SMI AND NOE

- 5.46 Figure 5.1, below, shows simplified balance sheets for SMI as at 20 February 2019³² in three situations (all on an IFRS basis):
- The "Actual" column shows the actual balance sheet as at 20 February 2019.
 - The "Immediately Post-Schemes" column shows what the balance sheet would have looked like as at 20 February 2019 had the Schemes been approved and become effective as at 20 February 2019. This would have removed all assets and liabilities from the SMI balance sheet, save those relating to the hull and liability business written by the Canadian branch (this assumes that the Canada Assumption Reinsurance will not have been implemented on or before the Effective Date). SMI will also be required to maintain its solvency capital, in accordance with the requirements of both OSFI and the PRA. The North Group has estimated that OSFI would require the SMI branch to retain capital amounting to US\$1.4 million. In those circumstances, the SCR for SMI would be equal to its MCR, which would be €3.7 million (roughly US\$4.2 million).
 - The "Ultimate Post Schemes" column shows what the balance sheet would have looked like as at 20 February 2019 had, following the Schemes, the following series of events then have occurred:
 - The Canada Assumption Reinsurance has been agreed, approved and become effective or the remaining Canada branch business has completely run-off;
 - With the formal permission of OSFI, SMI has ceased carrying on business in Canada, has arranged for its branch to be de-authorised and to release its Canadian Trust Fund assets, and has closed its Canadian branch office;
 - With the implementation of the Schemes, the run-off or assumption reinsurance of the Canadian business, and the run-off or novation of all other Residual Policies having been completed, the PRA has then cancelled SMI's permissions, granted under Part 4A of FSMA;
 - SMI has then released to its parent, NOE, all remaining assets and liabilities, leaving an empty balance sheet.

³² Based on SMI's Annual Report as at 20 February 2019.

FIGURE 5.1 SIMPLIFIED BALANCE SHEETS FOR SMI AS AT 20 FEBRUARY 2019 (IN US\$'000)

	Actual	Schemes	Immediately Post Schemes	Run-off / transfer of Canadian business, winding-up of SMI	Ultimate Post Schemes
Assets					
Investments	44,018	-39,576	4,442	-4,442	0
Reinsurers' share of technical provisions	50,120	-48,920	1,200	-1,200	0
Deferred acquisition costs	1,592	-1,592	0	0	0
Loans and receivables	38,893	-38,893	0	0	0
Intangible assets	0	0	0	0	0
Cash and cash equivalents	7,288	-4,415	2,873	-2,873	0
Total Assets	141,911	-133,396	8,515	-8,515	0
Liabilities					
Accumulated surplus attributable to members	54,666	-50,466	4,200	-4,200	0
Gross technical provisions	72,863	-70,548	2,315	-2,315	0
Other liabilities	14,382	-12,382	2,000	-2,000	0
Retirement benefit liability	0	0	0	0	0
Total Liabilities	141,911	-133,396	8,515	-8,515	0

5.47 I note that the gross technical provisions (and the reinsurers' share of those technical provisions) relating to the business to be covered by the Canada Assumption Reinsurance have run-off materially since 20 February 2019. As at 20 August 2019, the gross technical provisions had reduced to roughly US\$1 million.

5.48 Figure 5.2, below, shows NOE's balance sheet as at 20 February 2019 in three situations (all on an IFRS basis):

- The "Actual" column shows the actual balance sheet as at 20 February 2019.
- The "Immediately Post-Schemes" column shows what the balance sheet would have looked like as at 20 February 2019 had the Schemes been approved and become effective as at 20 February 2019. Post-Schemes, the balance sheet of NOE is essentially the sum of the balance sheets of NOE and SMI immediately prior to the Effective Date, less the following:
 - what is retained within SMI's balance sheet immediately post-Schemes;
 - the difference pre and post the Schemes in the value of SMI that had been included within NOE's pre-Schemes Investments (and in its pre-Schemes accumulated surplus), that difference being US\$40.3 million;
 - the amount included within NOE's "gross technical provisions" and within SMI's "reinsurers' share of technical provisions" that relates to NOE's reinsurance of SMI, which was US\$28.4 million (less the US\$1.2 million "reinsurers' share of technical provisions" retained within SMI in respect of the remaining Canadian branch business); and

I note that the Transferring Business will not be included within the business subject to the 90% quota share reinsurance provided by NEMIA.

- The "Ultimate Post Schemes" column shows what the balance sheet would have looked like as at 20 February 2019 had the events described in the third bullet point of paragraph 5.46, above, then occurred. The amounts transferring to NOE would be equal to the accumulated surplus within SMI, it being assumed that the run-off of the Residual Liabilities would generate no further surplus or deficit.

FIGURE 5.2 SIMPLIFIED BALANCE SHEETS FOR NOE AS AT 20 FEBRUARY 2019 (IN US\$'000)

	Actual	Schemes	Immediately Post Schemes	Run-off / transfer of Canadian business, winding-up of SMI	Ultimate Post Schemes
Assets					
Investments	166,054	-6,367	159,687	0	159,687
Reinsurers' share of technical provisions	805,975	20,531	826,506	0	826,506
Deferred acquisition costs	0	1,475	1,475	0	1,475
Loans and receivables	84,987	31,627	116,614	0	116,614
Intangible assets	19,047	0	19,047	0	19,047
Cash and cash equivalents	77,185	9,010	86,195	4,200	90,395
Total Assets	1,153,248	56,275	1,209,523	4,200	1,213,723
Liabilities					
Accumulated surplus attributable to members	228,161	9,468	237,629	4,200	241,829
Gross technical provisions	817,263	43,617	860,880	0	860,880
Other liabilities	55,551	3,190	58,741	0	58,741
Retirement benefit liability	52,273	0	52,273	0	52,273
Total Liabilities	1,153,248	56,275	1,209,523	4,200	1,213,723

5.49 I discuss the reserving strength of SMI and NOE in more detail in Section 6, below.

5.50 Figure 5.3, below, shows NOE's eligible own funds and solvency capital requirements as at 20 February 2019 in two situations:

- The "Pre-Schemes" columns shows the actual eligible own funds and solvency requirements as at 20 February 2019. The solvency requirements are shown net of the capital add-on (\$22.5 million). The capital add-on is described in Section 6, below, and had been held unaltered for several years in respect of risk associated with the NOE and SMI staff pension schemes. The scale of capital add-on needed had been declining and, in March 2019, the PRA authorised NOE to release it.
- The "Post-Schemes" columns show what the actual eligible own funds and solvency requirements would have been as at 20 February 2019 had the Effective Date been on or immediately before 20 February 2019. Again, the solvency requirements are shown net of the capital add-on for pension risk.

FIGURE 5.3 ELIGIBLE OWN FUNDS AND SOLVENCY CAPITAL REQUIREMENTS FOR NOE AS AT 20 FEBRUARY 2019 (IN US\$'000)

	Pre-Schemes		Post-Schemes	
	MCR	SCR	MCR	SCR
Eligible Own Funds	205,476	274,776	207,703	273,137
Solvency Requirement	32,213	128,854	32,705	130,822
Capital Cover Ratio	638%	213%	635%	209%

5.51 The impact of the Schemes on the eligible own funds and the overall solvency requirements for NOE is relatively small. This is because SMI is already included implicitly within the pre-Schemes NOE, as it is 100% owned by NOE. The Schemes affect the eligible own funds only insofar as the market value of SMI as an investment differs from the value of its assets less its liabilities when added to those of NOE. The composition of NOE's SCR is affected by the Schemes, but the increase in the insurance and credit default risks are largely offset by the reduction in the market risk.

5.52 I have not shown here SMI's eligible own funds and solvency capital requirements pre- and post-Schemes. Post-Schemes, until the PRA withdraws its permissions, SMI will maintain capital at a level at least that of the MCR (€3.6 million, which, at the exchange rates pertaining as at 20 February 2019, was the equivalent of US\$4.2 million). As can be seen from Figure 5.1, above, the liability that would have been retained within SMI immediately post-Schemes (i.e. the hull and liability business relating to the Canada branch) is much smaller than the MCR, and, as described in paragraph 5.20, above, has since decreased even further. The SCR immediately post-Schemes will be equal to the MCR, and the Capital Cover Ratio will be maintained close to 100%.

APPROACH TO COMMUNICATION WITH POLICYHOLDERS

- 5.53 The Companies have set out the approach that they intend to take in communicating information about the proposed Schemes to the affected policyholders and other parties. Their plans will be subject to approval by the Regulators and by the Court before the Companies can implement them.
- 5.54 The main objectives of the communications are to:
- Give those policyholders and others who might be affected by the Schemes the information that they need to understand the proposed changes;
 - Inform those policyholders and others who might be affected by the Schemes about the implications for them of the proposed changes;
 - Give those policyholders and others who might be affected by the Schemes access to further relevant information (beyond that in the communications pack);
 - Let those policyholders and others who might be affected by the Schemes know what steps they should take if they object to any of the proposed changes;
 - Maintain customers' confidence in NOE's willingness and ability to continue to meet its obligations in respect of the Transferring Business; and
 - Meet legal and regulatory requirements.
- 5.55 The Companies intend to notify the following groups about the Schemes:
- All members of NOE's open policy years;
 - All members of NOE's closed policy years with outstanding claims against NOE;
 - All holders of NOE fixed premium policies (save those Australian and New Zealand branch policyholders and US surplus lines policyholders whose policies were transferred from SMI and who were informed at the time of those transfers that such transfers formed part of the integration of SMI's business into NOE) with policies that inceptioned on or after 1 January 2017;
 - All holders of NOE fixed premium policies (save those Australian and New Zealand branch policyholders and US surplus lines policyholders whose policies were transferred from SMI and who were informed at the time of those transfers that such transfers formed part of the integration of SMI's business into NOE) with open claims;
 - All Transferring Policyholders of SMI with policies that inceptioned on or after 1 January 2017;
 - All Transferring Policyholders with open claims;
 - All reinsurers that have entered into an outwards reinsurance policy with SMI on or after 1 January 2017; and
 - All reinsurers of SMI against whom SMI has an outstanding claim.
- 5.56 Following the issue of notification letters to the groups above, the Companies also intend to provide copies of such letters to each new policyholder up to the date of the final Court hearing.
- 5.57 Where appropriate, communication with members and policyholders will be conducted via their brokers or the managing agents who are acting on behalf of the member/policyholder, or via the designated senior member/policyholder in relation to any ship entered for insurance in the name of multiple parties as joint members/policyholders.
- 5.58 The Companies will be applying to the Court for waivers in respect of the requirement to make similar direct notification to the following groups:
- Those members of NOE's closed policy years who do not have outstanding claims against NOE;
 - Policyholders of NOE's Australian and New Zealand branches and US surplus lines policyholders whose policies were transferred from SMI and who were notified at the time of those transfers that such transfers formed part of the integration of SMI's business into NOE;
 - Those Transferring Policyholders whose Transferring Policies were underwritten by SMI prior to 1 January 2017 and who do not have open claims;
 - Those reinsurers with reinsurance agreements relating to the Transferring Business but who have not entered into an outwards reinsurance policy with SMI within the last three years and against whom SMI has no outstanding claims.

- 5.59 The Companies will seek alternate contact details for those to whom notification 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.
- 5.60 In addition to direct, written correspondence, the Companies also plan to make indirect notification. FSMA indicates that such indirect notification will include notices in at least two national newspapers and one business paper in the UK and in the other EEA states in which the risks are situated. However, the North Group considers that, as a large proportion of the NOE and SMI policyholders are international shipping businesses, whose activities typically transcend national borders, it would be more appropriate to publish notices in the international edition of the Financial Times, rather than in EEA national newspapers. It further considers that those NOE and SMI policyholders that are not international shipping businesses tend to belong to certain communities of interest, such as fishing, recreational sailing, etc., whose activities again typically transcend national borders. Therefore, it considers that notices in specialist industry publications, such as Insurance Day, Lloyd's List, Fishing News, Fish Farmer Magazine, Intrafish Aquaculture, Aquaculture International, Yachting Monthly, Power & Motor Yacht and Boat International, would be more likely to be read by affected policyholders than would be notices in EEA national newspapers. In addition, a notice will be published once each in the London Gazette, the Edinburgh Gazette, the Belfast Gazette and the Jersey Gazette. The notifications will also be placed on relevant websites where applicable.
- 5.61 In addition to the above, SMI and NOE are aware that other EEA states have publication requirements that differ from those in the UK. I have been told that the Companies will seek a waiver from the requirement for publication in all EEA states and, should the waiver be granted, will rely only on individual notifications, the international edition of the Financial Times and the specialist publications to ensure notification of those policyholders based outside of the UK.
- 5.62 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 respond promptly to any such queries. It is intended that both this Report and the Supplementary Report will be published on the NOE and SMI websites, on pages dedicated to the Schemes, 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 and the Supplementary Report will likewise be made available at least one week before the date of the Court hearing at which the Scheme might be sanctioned.
- 5.63 I comment on this proposed approach to communications with policyholders in Section 8.

COSTS

- 5.64 All costs and expenses, including, without limitation, fees and disbursements of legal and financial advisers and accountants, incurred in connection with the Schemes and the transactions contemplated by the Schemes shall be paid by NOE.

6. THE IMPACT OF THE SCHEMES ON THE TRANSFERRING POLICYHOLDERS

INTRODUCTION

- 6.1 Under the Schemes, the Transferring Business will be transferred to NOE.
- 6.2 The main issues affecting the Transferring Policyholders as a result of the Schemes are likely to arise from relative differences in:
- The financial strength of NOE post the Effective Date compared with that of SMI pre the Effective Date. 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 NOE compared with those in SMI.
 - The policy servicing levels provided by NOE post the Effective Date compared with those currently enjoyed by the Transferring Policyholders.

In this section of this Report, I deal with each of these in turn.

- 6.3 I note that the reserves held on an IFRS basis differ from the TPs that are used to determine the own funds available to meet the solvency capital requirements under Solvency II. However, the best estimate of the claims liabilities that underlie those shown in the Report & Accounts is usually used as the base for the best estimate of the claims provision under Solvency II, which then forms a key part of the TPs.
- 6.4 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 and Financial Condition Report ("SFCR"), 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")) 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 private metrics, or figures by which those values could be calculated. In this Report, I have considered the extent to which SMI and NOE each hold capital in excess of various solvency capital measures. Each entity will have different Capital Cover Ratios for different solvency measures. Where permitted (e.g. when dealing with publically available information), 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 SMI (PRE-SCHEMES)

- 6.5 As set out in Figure 4.3, above, in its statutory accounts as at 20 February 2019, SMI held gross technical provisions of US\$72.9 million (made up of US\$15.8 million of UPR and US\$57.1 million of outstanding claims). Reinsurers' share of technical provisions totalled US\$50.1 million (made up (after rounding) of US\$10.6 million of UPR and US\$39.6 million in respect of claims outstanding).
- 6.6 In this section of the Report, I provide details of my review of the reserve strength of SMI. As the work underlying the reserves booked by SMI has been used in its capital calculations (albeit indirectly), the appropriateness of these reserves is important in assessing the security currently afforded to the Transferring Policyholders.
- 6.7 I have been provided with details of the outstanding claims provisions for SMI as at 20 February 2019, the process by which the provisions were established and details of the actuarial review that underlies those provisions. The outstanding claims provisions so developed and included in SMI's financial statements (as at 20 February 2019) were prepared in accordance with IFRS.

- 6.8 I have not attempted to review in detail the calculations performed by the actuary responsible for the actuarial review. Instead, I have reviewed the process by which reserves were set, the approach followed by the actuary, the key areas of reserve uncertainty and the apparent strength of the reserves based on this review.

Reserving Policy

- 6.9 SMI's policies may be written on a direct or reinsurance basis, and may be for 100% or only part of the risk. The reserving policy does not differ across these bases of business.
- 6.10 All reported claims are recorded in one of two databases, one operated by SMI and the other (in respect of the Canadian branch business only) held by HMU. For direct business, SMI has access to all claims data wherever it is held. In respect of inwards reinsurance business, data is held by third parties.
- 6.11 For each reported claim, SMI estimates the cost of settling the claim, gross of claims handling costs and net of any policyholder or third party recoveries, on a "worst most likely" basis. The case estimates are based on the information available in relation to a claim at the time of the review, together with the judgement of the claim handlers, and are subject to management review and approval in accordance with SMI's claim authority guidelines.
- 6.12 The case estimates make no allowance for the time value of money.
- 6.13 The SMI Board determines the provision for outstanding claims to be included within the financial statements, having regard to recommendations made by the reserving actuary (this role has been outsourced to an external firm of actuarial consultants, and the same firm has assumed the role for several years). The reserving actuary projects the claims costs to derive a statistical measure of the final costs of claims settlement, and SMI seeks to hold provisions in respect of the material lines of business at a confidence level set and periodically reviewed by the SMI Board (80% as at 20 February 2019).
- 6.14 It should be noted that the reserving actuary, on instruction from the managers of SMI, prepared the projections, results and report, ignoring the impact of the transfer of SMI's Australian and New Zealand businesses.

Actuarial projections of outstanding claims costs

- 6.15 For projection purposes, SMI's reserving actuary segments most of the business into two main classes of business (I discuss the remainder of the business later in this section of the Report) and into six regions, as follows:
- Classes:
 - Hull
 - P&I
 - Regions:
 - Australasia
 - UK and Ireland
 - USA
 - Canada
 - Rest of Europe
 - Other.
- 6.16 For internal purposes, the final projections of the SMI reserving actuary are subsequently allocated into component territories (e.g. Australia and New Zealand within Australasia) and/or sub-class. This allocation to more granular levels is often required to allow application in the reserving of the proportional reinsurance treaties. However, the reserving exercise is not performed at the level of individual territories or sub-classes.

- 6.17 The SMI reserving actuary has used two generally accepted actuarial methods (specifically the Chain Ladder³³ and Bornhuetter-Ferguson ("B-F")³⁴ methods) to estimate ultimate claim amounts. These estimated ultimate claim amounts are on a "best estimate" basis, in that they are intended to be unbiased estimates with no margin for either optimism or prudence. I interpret this measure to be on a basis higher than a 50% confidence level (as the claim distribution is expected to be positively skewed³⁵). The SMI reserving actuary has then used a statistical technique (the "Mack Method", named after Thomas Mack, the statistician who developed it) to estimate the ultimate claim amounts at the 80th percentile confidence level (I discuss the Mack Method in paragraph 6.28 onwards). The outstanding claim provisions are then calculated by deducting from these estimates of the ultimate amounts the payments that have already been made. As such, the outstanding claim provisions are also at the estimated 80th percentile confidence level (meaning that one can expect to be 80% confident that the ultimate future payments in respect of outstanding claims will not exceed this level), and, arguably, contain a further implicit margin of prudence due to the provisions making no allowance for the time value of money.
- 6.18 The projections underlying the booked provisions have been based wholly on incurred claims data and on the historic quarterly development patterns of that incurred claims data. The incurred amounts include all loss adjustment expenses that have been allocated to specific claims (e.g. legal fees). The data used has been collated in US Dollars, with raw data that is expressed in other currencies being converted to US Dollars at the exchange rate pertaining as at the date of the valuation (e.g. 20 February 2019).
- 6.19 The projections have been performed using data split by policy year, to generate estimates of the ultimate claim amounts by policy year. These claim amounts have then been allocated between the accident years, in order to determine the outstanding claim amounts in respect of business that had been earned as at the date of the provisions.
- 6.20 The projections have been performed using data gross of reinsurance. The estimated ultimate claim amounts have then been reduced by the expected ultimate recoveries under the reinsurance programmes. It has been assumed that reinsurance recoveries will be made as anticipated and there is no bad debt other than that directly provided for by SMI. No allowance is made for ceded IBNR provisions in respect of non-proportional reinsurance. This introduces a small margin of prudence in the estimation of the provisions net of reinsurance.
- 6.21 The key assumptions underlying the Chain Ladder and B-F methods as applied to incurred data are as follows:
- The historic incurred development patterns are indicative of future development, which in turn implies the following further assumptions:
 - Case reserving standards are consistent (and are applied consistently) over time;
 - Claims inflation is broadly stable; and
 - Claims settlement processes are broadly unchanged over time.

³³ The Chain Ladder method is an actuarial method that is commonly used to estimate claim reserve amounts. The method considers the historical development of reported amounts (which might be incurred claims, cumulative payments, numbers of claims, etc.) and then extrapolates this historical development into the future in order to estimate future development. By applying the estimated future development to the current amounts, one can then estimate the ultimate amounts. The method involves some actuarial judgement in determining the assumption for the pattern of future claims from the historical data.

³⁴ The B-F 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 expected ultimate losses on an a priori basis, the latter for any particular policy or accident year being typically based on the underwriter's view or estimates of the ultimate loss ratios relating to earlier policy or accident years. For more recent policy or accident years, more weight is given to the expected ultimate losses (where claim based methods are less reliable); for older policy or accident years more weight is given to the Chain Ladder method (where claim data provides more information).

³⁵ 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.

- The estimation (and selection) of the initial expected year loss ratios ("IELR"s), used as an assumption in the B-F method. SMI's reserving actuary has used an average of historical ultimate loss ratios, which he has derived using the Chain Ladder method for each prior policy year, those ratios being weighted by both the percentage of claims estimated that have developed to date and the premium written in each policy year. In this way, the Chain Ladder estimates in respect of recent years are weighted moderately, as the percentage developed is low. The number of years considered in the computation of the average was determined by a visual inspection of loss ratios so as to reflect any obvious trends in underwriting results, with fewer prior years being taken into consideration the stronger any apparent increasing or decreasing trend in the loss ratios. This approach assumes that the underlying riskiness of the business relative to the premiums charged remains unaltered from year-to-year, i.e. there is no difference from year-to-year in market competitiveness.
- 6.22 Where these assumptions do not apply, or are not supported by the data, the SMI reserving actuary has made adjustments intended to improve the reliability of the estimated results. For example, large open incurred claims developments were removed from the corresponding triangulations prior to analysing the historic development and assessing future development patterns. Development patterns derived in this way were then applied to the complete triangles to arrive at estimates of ultimate incurred losses for all years of account.
- 6.23 The reserves for the other classes of business (aquaculture, personal accident and inwards reinsurance) are estimated by SMI's Finance Team.
- For Personal Accident the team uses a simple chain ladder method. The gross reserves in respect of this class are less than 1% of the total gross outstanding claims reserves.
 - Aquaculture claims have to be notified within 72 hours of the claims incident occurring, so there is little need for provisions in respect of IBNR claims. Provisions that are additional to the case estimates already made in respect of open claims are considered on a case-by-case basis, with the Finance Team liaising with the Aquaculture department to determine the scope for releases or further adverse development.
 - The reserves for Inwards Reinsurance were originally set assuming a 100% loss ratio for each contract, with those reserves then being released gradually to blend into emerging experience. This business is in run-off.
- 6.24 I note the following in respect of the approach taken by the SMI Reserving Actuary:
- The final selections of many reserving assignments are, like those of SMI, the same as the results of projecting incurred claims data to its ultimate position. This reflects the fact that the incurred claims data incorporates case estimates of the amounts still to be paid and hence is richer in content than, say, claim payment data. However, it is unusual for reserving actuaries to conduct no projections using claim payment data if such data is available.
 - Neither the SMI Reserving Actuary nor SMI's Finance Team make any allowance in their reserve estimates for the future emergence of claim types that have not historically been represented in the claims data to date. As such, they make no allowance for the possible exposure of this business to latent claims. This is not untypical.
 - Many reserving actuaries segment claims by claim type, prior to projecting them to their ultimate values. This is because claim types tend to develop differently from one another (e.g. damage claims tend to be settled quicker than those involving bodily injury). Neither the SMI Reserving Actuary nor SMI's Finance Team have projected the claims by claim type due to data split by both geography and claim type being of insufficient volume for many such segments to be statistically credible.
- 6.25 From my review of the various documents supporting the reserve calculations, as I have described above, I am satisfied that:
- the reserving methodologies adopted by the SMI reserving actuary are broadly consistent with usual market practice; and
 - the major assumptions adopted by the SMI reserving actuary appear reasonable in the context of the underlying portfolios and of my market knowledge.

Therefore, I conclude that SMI's best estimate reserves as at 20 February 2019 appear reasonable.

- 6.26 I have been told by the reserving actuary that, since 20 February 2019, the SMI case reserving philosophy has changed to be in line with that of NOE (in general, NOE's case reserves for personal injury claims have tended to be more prudent than those set by SMI). Adjustments will be needed to the reserving models, methods and assumptions used to make projections to ensure that this change in case reserving philosophy will have a neutral impact on the best estimate liabilities that feed into the TPs. As at the date of this Report, this work to adjust the reserving models was ongoing. I will consider developments subsequent to the date of this Report when preparing the Supplementary Report.

Reserve uncertainty

- 6.27 The historic incurred development experience relating to SMI business has been volatile and not very consistent from policy year to policy year. The greater the volatility in the historic experience the greater the uncertainty in the selection of future claims development factors, as well as in the choice of IELRs. Particular sources of uncertainty include:
- Legislative and regulatory changes can affect the business in many ways, for example in claims frequency, in claim amounts and in the rate of claims development.
 - The data segments into which the business has been split are relatively small, meaning that individual claims that have unusual development, even if the claims themselves are not very big, can distort those historic development patterns. As a result, many of the segments have experienced widely differing development patterns between the policy years.
 - While SMI has not changed its underwriting philosophy in recent years, it is possible that even small changes in its underwriting practices and changes in its competitors' underwriting philosophy and practices have led to changes over time in the profile of its business. Therefore, historical claim development patterns might not be applicable to business written more recently.
- 6.28 As noted in paragraph 6.17, above, the SMI reserving actuary has used a statistical technique known as the Mack Method to estimate the ultimate claim amounts, net of reinsurance, at the 80th percentile confidence level. The Mack Method³⁶ is a commonly used approach to estimating the standard error of reserve estimates derived using a Chain Ladder projection, which therefore gives a measure of the uncertainty contained within the results. The standard error thus estimated is distribution-agnostic and its estimation does not rely on any additional assumptions, other than those already implicit in the Chain Ladder methodology.
- 6.29 In using the Mack Method, the total reserve standard deviation for each class is estimated by multiplying the calculated standard error, expressed as a proportion of the reserves estimated using the Mack Method, by the best estimate of the reserves calculated using the methods described earlier in paragraph 6.17, above. While the Mack Method provides estimates of the standard deviation of the reserves, because it is distribution-agnostic it does not give any information regarding the distribution of the aggregate future losses.
- 6.30 In estimating the outstanding claims at the 80th percentile confidence level, the reserving actuary has applied the Mack Method to incurred claims data, net of reinsurance, by accident year and separately for the different classes of business. Furthermore, he has assumed that the outstanding claims payments, net of reinsurance, follow a lognormal distribution, with mean equal to the net earned best estimate reserves as at 20 February 2019.
- 6.31 It should be noted that the Mack Method is constrained by the data, in that:
- It assumes that the variability in future development factors will be the same as that seen in the past. Historic data is finite and therefore cannot reflect the full range of possible future variability.
 - The historic data might include the impact of events (e.g. one-off changes in the claims environment) that will not be repeated in the future. As a result, the Mack Method might overstate future variability.
 - Likewise, future claims development might be distorted by events (e.g. one-off changes in the claims environment) that have not been seen in the past. As a result, the Mack Method might understate future variability.

³⁶ Full details of this method are available in the original paper, *Distribution-free Calculation of the Standard Error of Chain Ladder Reserve Estimates*, *ASTIN Bulletin*, Volume 23(2), p213, 1993.

- 6.32 The results at the 80th percentile are also dependent on the choice of distribution of the outstanding claims payments, net of reinsurance.
- 6.33 I consider the Mack Method to be a reasonable approach to illustrating reserve variability, but caution that it does not provide a definitive view of that variability. I consider the way that the SMI reserving actuary has applied the Mack Method to the best estimate reserves, net of reinsurance, as at 20 February 2019 to be reasonable.
- 6.34 I note that, subsequent to 20 February 2019, the North Group does not expect to request the SMI Reserving Actuary to calculate the 80th percentile confidence level, rather it expects that he will provide just the best estimates of the outstanding claim amounts, both gross and net of reinsurance. The North Group then expects that it will evaluate the appropriate margin, over and above the best estimate amounts, to include in the technical provisions within the SMI balance sheet.

Unallocated Loss Adjustment Expenses

- 6.35 The provision for future Unallocated Loss Adjustment Expenses ("ULAE") is estimated by SMI's Finance Department, which considers the expenses of the claims department (staff costs and overhead) in light of the anticipated run-off period for claims. Management then reviews the appropriateness of the provision thus calculated, using its experience and judgement.

Solvency II Technical Provisions

- 6.36 TPs are conceptually valued on a market consistent basis, i.e. the amount a third party would require 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 TPs.
- 6.37 SMI's starting point for calculating its TPs is the best estimate claims reserves calculated on the IFRS basis as described above (which underlie the booked reserves). SMI performs the calculation of the TPs itself, while the Actuarial Function is outsourced for both SMI and NOE to a firm of actuarial consultants (this differs from the firm of actuarial consultants that assesses SMI's reserves as calculated on the IFRS basis). I have been provided with a copy of the Actuarial Function Report ("AFR") prepared by the Actuarial Function in respect of the TPs as at 20 February 2019. In the AFR, the Actuarial Function describes and assesses the process undertaken by SMI in calculating its TPs as at 20 February 2019. The Actuarial Function considered:
- the data;
 - the models, methods and assumptions underlying the reserving on an IFRS basis;
 - the methods and assumptions underlying the calculation of the TPs;
 - the calculation of the TPs; and
 - the adequacy of the TPs.
- 6.38 In the AFR, the Actuarial Function identified some areas whereby SMI's process for calculating its TPs could be enhanced or made more robust, but did not identify any significant deficiencies likely to result in material misstatement of SMI's TPs.
- 6.39 SMI has made a number of adjustments to its held reserves to calculate its TPs, as set out below (see Appendix I for further information):
- Removal of both ULAE and the margin that takes the provision for outstanding claims from a "best estimate" to the booked provision at the 80th percentile;
 - Allowance for future premiums on incepted business (i.e. recognition of profits expected to arise on such business);
 - No allowance is made for Bound But Not Incepted ("BBNI") business (e.g. recognition of profits expected to arise in respect of tacit renewals, multi-year contracts, delegated authorities and any quotes that SMI was legally obliged to honour if the quote were accepted) as such business is not considered to be material for SMI;

- Allowance for ENIDs – SMI adopted a load equal to half of that calculated for NOE (see below), because it considered that the main contributors to ENIDs are latent claims and that its exposure to latent claims is roughly half that of NOE, due to the different profile of its insureds;
- Reinsurance bad debt reserve (calculated by matching default rates provided by Standard & Poor's to each reinsurer with outstanding recoveries – all reinsurers have been assumed to have a credit rating of “A”, even though, in reality, they range from “A” to “AAA”);
- Allowance for discounting, using the relevant risk-free interest rate term structure for each material settlement currency;
- Future expenses for running off the business (ULAE and other “non-ULAE” expenses, such as those relating to depreciation (tangible and intangible), investment management expenses and policy administration); and
- Risk margin (i.e. the additional payment that a knowledgeable third party would require in order for it to assume the liabilities covered by these TPs) – this is based on the future SCRs required to back SMI's business as it runs off into the future (excluding risks not relevant to such a run-off, such as those associated with new business), discounted to a present value using discount rates as prescribed by EIOPA.

6.40 The process and assumptions used in respect of SMI are typical of those that I have seen adopted by other UK insurance companies.

Conclusion with regard to the reserve strength of SMI pre-Schemes

6.41 Based on my review of the technical provisions of SMI (both on an IFRS and Solvency II basis) as at 20 February 2019, as described above, I have concluded that

- the methodologies and major assumptions underlying the reserve analyses as performed by SMI as at 20 February 2019 are reasonable;
- the best estimates of unpaid claim amounts also appear reasonable; and
- the TPs booked by SMI as at 20 February 2019 include appropriate margins and other adjustments over those actuarial indications.

I therefore conclude that SMI's reserves (both on an IFRS and Solvency II basis) appear reasonable as at 20 February 2019, notwithstanding the uncertainty present.

RESERVE STRENGTH OF NOE (PRE-SCHEMES)

6.42 As set out in Figure 4.1, above, in its statutory accounts as at 20 February 2019, NOE held gross technical provisions of US\$817.3 million (made up of US\$15.3 million of UPR and US\$802.0 million of outstanding claims). This includes the inwards reinsurance, on a quota share basis, of business written by SMI, as well as the Australian and New Zealand branch business transferred to NOE from SMI during the preceding financial year. Reinsurers' share of technical provisions totalled US\$806.0 million (made up of US\$5.6 million of UPR and US\$800.4 million in respect of claims outstanding).

6.43 In this section of this Report, I provide details of my review of the reserve strength of NOE. As the claims reserves booked by NOE have been used in its capital calculations (albeit indirectly), the appropriateness of these reserves is important in assessing the security currently afforded to the existing NOE policyholders and which might be afforded, post the Scheme, to the Transferring Policyholders.

6.44 I have been provided with details of the outstanding claims provisions for NOE as at 20 February 2019, the process by which the provisions were established and details of the actuarial review that underlies those provisions. The outstanding claims provisions so developed and included in NOE's financial statements (as at 20 February 2019) were prepared in accordance with IFRS.

6.45 I have not attempted to review in detail the calculations performed by the actuary responsible for the actuarial review. Instead, I have reviewed the process by which reserves are set, the approach followed by the actuary, the key areas of reserve uncertainty and the apparent strength of the reserves based on this review.

Reserving Policy

- 6.46 NOE incurs claims in respect of cover provided to its own policyholders and as a result of its membership of the International Group (through which it and the other members of the International Group share in each others' claims arising above a value determined under the International Group Agreement).
- 6.47 The NOE Board determines the provision for outstanding claims to be included within the IFRS financial statements, having regard to recommendations made by the reserving actuary (this has been outsourced to external firm of actuarial consultants and the same firm has assumed the role for several years). Unless stated otherwise below, the NOE reserving actuary projects the claims costs to derive a statistical measure of the final costs of claims settlement, and NOE seeks to hold provisions in respect of the material lines of business at a confidence level set and periodically reviewed by the NOE Board. Reserves are currently set at the 95th percentile (other than those in respect of the business ceded to NOE by SMI, as explained in paragraph 6.54, below) – in my experience, this is a high percentile but reflects both the underlying uncertainty within a best estimate of the ultimate unpaid claim amounts and the mutual nature of NOE.

NOE Members' Non-Latent Claims

- 6.48 For each reported claim, NOE estimates the cost of settling the claim, gross of claims handling costs and net of any policyholder or third party recoveries, on a "worst likely" basis. The case estimates are based on the information available in relation to a claim at the time of the review, together with the judgement of the claim handlers, and are subject to management review and approval in accordance with NOE's claim authority guidelines.
- 6.49 The case estimates make no allowance for the time value of money.

NOE Member's Latent Claims

- 6.50 Latent claims (such as those relating to industrial diseases, e.g. noise induced hearing loss) are reserved at management's conservative estimate having regard to actuarial advice and relevant claims experience.

International Group Pool Claims

- 6.51 All reported International Group pool claims are recorded in NOE's claims database. The amounts recorded are based on reports issued by members of the International Group (i.e. they are not case estimates set by NOE claims staff), and are at NOE's current estimated participating percentage share. The participating percentage share is calculated by the International Group's actuary and is subject to adjustment based on entered tonnage, premiums and NOE's own claims record in relation to the pool. An adjustment is made where management anticipates material variation between the estimated and likely actual participating percentage. The provision in the database in respect of International Group pool claims reported is subject to management review and approval.
- 6.52 The provision for outstanding International Group pool claims in NOE's IFRS financial statements is based upon estimates of ultimate claim amounts performed by an independent actuary (who is neither the SMI reserving actuary nor the NOE reserving actuary), subject to review and possible amendment by NOE management.

SMI business

- 6.53 NOE reinsures SMI's Hull and Machinery and P&I liability business on a quota share basis, taking 60% for Hull and Machinery risks attaching 1 January 2012 onwards, 75% for P&I liability risks attaching 1 January 2012 to 31 December 2014, and 60% for P&I liability risks attaching 1 January 2015 onwards.
- 6.54 NOE holds reserves for this business estimated at the 80th percentile confidence level, consistent with the confidence level at which they are held in SMI's reserves. NOE does not perform its own assessment of these liabilities, instead relying on those booked by SMI's Board.
- 6.55 Although SMI transferred this business to NOE prior to 20 February 2019, the reserves in respect of the business of NOE's Australian and New Zealand branches were estimated as at 20 February 2019 by the SMI reserving actuary, whose estimates at the 80th percentile were adopted (after review) by NOE for inclusion in its IFRS reserves.

Actuarial projections of outstanding claims costs

- 6.56 The NOE reserving actuary segments most of the business for projection purposes into two main classes of business (I discuss the remainder of the business later in this section of the Report), as follows:
- P&I
 - FDD.
- 6.57 The P&I and FDD data is further split between charterer and non-charterer business, and the claims for all three classes are split between "large" and "small", the distinction between large and small differing by class of business (once a claim has been defined as "large" it remains so, even if subsequently it diminishes in size) . P&I claims data is also split between the types of claim.
- 6.58 Claims data is projected gross of reinsurance (but see paragraph 6.59, below) to produce estimates of the ultimate claim amounts, gross of reinsurance, from which can be obtained:
- estimates of outstanding claim amounts, gross of reinsurance, by subtracting claim amounts already paid;
 - estimates of ultimate claim amounts, net of reinsurance, by subtracting expected ultimate recoveries against the reinsurance programmes; and
 - estimates of outstanding claim amounts, net of reinsurance, by subtracting from the estimates of outstanding claim amounts gross of reinsurance the recoveries already made in respect of the open claims against the reinsurance programmes.
- 6.59 The NOE reserving actuary has assumed that reinsurance recoveries will be made as anticipated and there is no bad debt, other than that directly provided for by NOE. However, allowance has been made for possible exhaustion of individual covers.
- 6.60 To allow for the changes in NOE's reinsurance programme, as explained in paragraph 6.53, above, NOE's reserving actuary did the following:
- for Policy Years 2012 and prior, he considered data gross of all reinsurance other than facultative reinsurance; and
 - for Policy Year 2013 onwards, he considered data gross of all reinsurance including facultative reinsurance.
- For FDD, the data is identical gross and net of facultative reinsurance. Therefore, for P&I business, the estimates gross of reinsurance are in fact net of facultative reinsurance for Policy Years 2012 and prior.
- 6.61 The claim amounts include all loss adjustment expenses that have been allocated to specific claims. The data used has been collated in US Dollars, with raw data that is expressed in other currencies being converted to US Dollars at the exchange rate pertaining as at the date of the provisions (e.g. 20 February 2019).
- 6.62 For non-large claims, NOE's reserving actuary has used the Chain Ladder method to estimate ultimate claim amounts but has also applied the Chain Ladder method stochastically (using 5,000 iterations), as well as deterministically, giving rise to a statistical analysis of likely ultimate results. The ultimate claim amounts estimated deterministically are on three bases: "best likely", "most likely" and "worst likely". These methods have been applied to both incurred claims data and claim payments data, and on the historic quarterly development patterns of that claims data (although the selected results have been based upon the projections of the incurred data only).
- 6.63 For the most recent two policy years, to allow for the relative immaturity of the claims data, the NOE reserving actuary has also considered the results of projections made using an analysis of prior year projected losses per unit of risk. He has applied more weight to the results of this methodology and less to the Chain Ladder results the greater the immaturity of the data.
- 6.64 The key assumptions underlying the Chain Ladder method are as described in paragraph 6.21, above.
- 6.65 For large claims, the deterministic projections are performed as described above in respect of the non-large claims. However, the stochastic modelling is different in that:
- The future development of known large claims is modelled stochastically, after splitting the historic data into three bands relating to the incurred amount of the claims; and

- The number of large claims is also modelled stochastically, to enable the generation of numbers of claims that ultimately will be large but whose incurred value (if indeed they have yet been reported) currently lies below the relevant large loss threshold. To each such future large loss is allocated a sampled ultimate amount, based on the projected ultimate average values of claims in the respect of the claim's policy year and of those policy years two years either side. An adjustment is made so as to avoid double-counting the impact of these claims that will become large but which are currently also included within the analysis of non-large claims.
- 6.66 This approach facilitates the application of those parts of the reinsurance programme that apply to individual claims on a case-by-case basis. I note that adjustments have been applied in respect of the two very large claims in Policy Year 2013, the future development of which is considered unlikely to follow the usual patterns.
- 6.67 I note that:
- It has been assumed that there have been no changes between the policy years in the underwriting or terms and conditions that might have affected the development of claims, other than those that would have been seen in the change in the mix of business and claim types. I am unaware of any reason why this might not have been a reasonable assumption;
 - No allowance has been made for any change in the rate of development or settlement of claims. NOE's reserving actuary has looked for but has found little evidence of any such changes;
 - NOE's reserving actuary compares data movements with those anticipated by prior reserve projections, as a way of sense checking results; and
 - There is no geographical split of the data. In the past, the data was also split by claim type. I have been told that the results of projections made using data aggregated by claim type were very similar to the aggregated results of projections made using claim data by separate claim type. Therefore, NOE and NOE's reserving actuary concluded that the additional work engendered by projecting data split by claim type was not justified by any added insight or reliability of the resulting estimates.
- 6.68 With effect from 20 November 2019, NOE has changed its reserving models, methods and assumptions to a deterministic approach. This will enable better traceability and visibility of assumptions. It will also mean that the approach taken to reserving for SMI and for NOE is broadly similar. As at the date of this Report, the work was ongoing to determine what, if any, impact this change would have on the best estimate claims liabilities that feed into NOE's TPs. I will report further on this within the Supplementary Report.

Asbestos

- 6.69 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, which, 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.
- 6.70 Exposure to asbestos is most frequently attributed to 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.
- 6.71 NOE has experienced several claims resulting from claimants' exposure to asbestos, that exposure occurring during the 1960s and 1970s. Typically, such claims would relate to ship-workers and dockworkers being exposed when asbestos was exported/imported, or ship-workers exposed to asbestos in the fabric of a vessel. For each such claim, a case estimate is set at an appropriate level by an experienced claims adjuster and NOE also provides for IBNR reserves in respect of asbestos-related claims based upon actuarial analysis and advice.

- 6.72 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. Various studies have been conducted in the US regarding likely future levels of claim payments in respect of asbestos-related claims. Similarly, an IFoA Working Party, known as the Asbestos Working Party ("AWP"), has carried out detailed research into the area of UK asbestos-related liabilities, and has produced a number of reports (most recently in 2009), which have included estimates of the UK insurance industry's ultimate cost in respect of such claims. Many insurers around the world use such reports to inform their estimates of their ultimate liabilities in respect of asbestos-related claims.
- 6.73 The typical approach taken by actuaries to estimate liabilities relating to future asbestos-related 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.
- 6.74 NOE uses such a frequency-severity model in order to estimate its future asbestos-related costs. The model was developed several years ago by the external firm of actuaries to which NOE has outsourced the role of NOE's reserving actuary. However, the model is operated by NOE.
- 6.75 NOE makes little use of the work of the AWP or of the results of the US studies, and tends to use its own data as the basis for parameterising its model. Its argument is that its exposures to asbestos-related claims are different from that of most other affected insurers (and hence of those supplying data to the AWP or to the US studies):
- The covers generating asbestos-related claims are not Employers' Liability/Workers' Compensation cover; and
 - The exposures are international, not focused on the UK or on the US.
- This can be seen in the year-on-year emergence within NOE of asbestos-related claims, which have been consistently lighter than these external studies would have suggested likely.
- 6.76 In my experience, it is more usual in reserving for asbestos-related claims to make some use of the AWP reports and/or the US studies. However, I agree that NOE's risk profile differs from those of most of the insurers included within those studies and, therefore, that the results of studies are of limited applicability when estimating the ultimate cost to NOE of asbestos-related claims. I note that NOE periodically commissions independent external reviews of its asbestos-related reserves and uses the output of those reviews to re-parameterise its model. The most recent external review was completed in January 2016. NOE has told me that there has been no indication that NOE's experience of asbestos claims has deteriorated since that date.
- 6.77 The reserves held by NOE as at 20 February 2019 in respect of asbestos-related claims totalled US\$4.8 million, gross of reinsurance, comprising case reserves of US\$1.5 million and IBNR provisions of US\$3.3 million. This is roughly 0.6% of the total outstanding claims reserves held by NOE as at 20 February 2019, gross of reinsurance. Therefore, the impact of asbestos-related claims upon NOE's reserves, including upon the uncertainty within those reserves, is small.
- 6.78 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 and appropriate levels of claim reserves.

Claims Reserves - Future in-house claims handling costs for previous policy years

- 6.79 The provision for future ULAE is estimated by NOE's Finance Department, which considers the expenses of the claims department (staff costs and overhead) in light of the anticipated run-off period for claims. The provision thus calculated is reviewed for appropriateness by members of management, using their experience and judgement.

Reserve uncertainty

- 6.80 In considering the approach taken to estimating the provisions necessary at the 95th percentile confidence level (in respect of all of the business other than the inwards reinsurance of SMI), I note that the stochastic approach taken assumes that the variability in future development factors will be the same as that seen in the past. As I discussed in the context of the Mack Method and SMI's reserves, in paragraph 6.31, above, historic data is finite and therefore cannot reflect the full range of possible future variability. For example, future claims development might be distorted by events (e.g. one-off changes in the claims environment) that have not been seen in the past. As a result, this approach might understate future variability. Likewise, the historic data might include the impact of events (e.g. one-off changes in the claims environment) that will not be repeated in the future. As a result, this approach might overstate future variability. This approach is also dependent on the assumed distribution of the future development factors.
- 6.81 Despite these reservations, I consider the stochastic approach pursued by the NOE reserving actuary to be a reasonable approach to illustrating reserve variability, but caution that it does not provide a definitive view of that variability. I consider the way that the NOE reserving actuary has applied the stochastic methodology to the reserves, as at 20 February 2019, to be reasonable.
- 6.82 From my review of the various documents supporting the reserve calculations, I am satisfied that the reserves booked by NOE are reasonably consistent with its reserving policy to hold provisions estimated at a 95th percentile confidence level (80th percentile in respect of the inwards quota share reinsurance of SMI).

Solvency II Technical Provisions

- 6.83 NOE's starting point for calculating TPs is the IFRS basis as described above. NOE performs the calculation of the TPs themselves, while the Actuarial Function is outsourced for both SMI and NOE to a firm of actuarial consultants (this differs from the firm of actuarial consultants that assesses NOE's reserves as calculated on an IFRS basis). NOE has provided me with a copy of the AFR that was prepared by the Actuarial Function in respect of its review of NOE's Solvency II technical provisions as at 20 February 2019. In the AFR, the Actuarial Function describes and assesses the process undertaken by NOE in calculating the TPs as at 20 February 2019. As per SMI, the review identified some areas whereby the process for calculating NOE's TPs could be enhanced or made more robust but did not identify any significant deficiencies likely to result in material misstatement of NOE's TPs. The review followed the same approach as for the SMI TPs, as set out in paragraph 6.37, above.
- 6.84 A number of adjustments have been made to the held reserves to calculate NOE's TPs as follows (see both paragraph 6.39, above, and Appendix I for further information):
- Removal of both ULAE and the margin that takes the provision for outstanding claims from a "best estimate" to the booked provision estimated at the 95th percentile (80th percentile for the business ceded by SMI);
 - Allowance for future premiums on incepted business (i.e. recognition of profits expected to arise on such business);
 - Inclusion of Bound But Not Incepted ("BBNI") business (e.g. in respect of delegated authorities);
 - Allowance for ENIDs;
 - Reinsurance bad debt reserve;
 - Allowance for discounting;
 - Risk Margin; and
 - Solvency II expenses, split between ULAE and non-ULAE.
- 6.85 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 NOE pre-Schemes

- 6.86 Based on my review, as described above, of the technical provisions of NOE (on both IFRS and Solvency II bases) as at 20 February 2019, I have concluded that
- the methodologies and major assumptions underlying the reserve analyses as performed by NOE as at 20 February 2019 are reasonable;

- the best estimates of unpaid claim amounts also appear reasonable; and
- the reserves booked by NOE as at 20 February 2019 include margins, both implicit and explicit, over those best estimates.

I therefore conclude that NOE's claims reserves appear reasonable as at 20 February 2019, notwithstanding the uncertainty present.

RESERVE STRENGTH OF NOE (POST-SCHEMES)

- 6.87 Post the Effective Date, the Transferring Business will be included 100% within NOE, and the reserves for the Transferring Business will be wholly included within the reserves for NOE. Pre-Schemes, the NOE reserves partially included reserves in respect of the SMI business due to NOE's quota share reinsurance of much of SMI's business.
- 6.88 I have discussed with NOE's management what, if any, plans it has to change its approach to reserving post the Effective Date. I have been told that, initially at least, there would be no changes to NOE's reserving policy. The former SMI business will form a separate class of business within NOE (alongside P&I, FDD and War) and will be accounted for separately (i.e. not on a mutual basis). It is intended that reserves will continue to be booked at the 95th percentile confidence level for P&I, FDD and War and at the 80th percentile confidence level for the ex-SMI business and that sold subsequent to the Scheme under the Sunderland Marine brand. The reserving policy, including the confidence levels at which reserves will be booked, is reviewed annually by the NOE Board and it is possible that, at some future date, the NOE Board will revise the policy (and possibly the target confidence levels). However, that will be in response to the then prevailing conditions and NOE's own circumstances.
- 6.89 As noted in paragraph 6.68, above, with effect from 20 November 2019, the reserving models used in respect of the NOE business have been revised, to make them more transparent. This development is not related to the Scheme. While it is possible that the change in model will result in a change in the best estimate reserves, such a change in the reserves is not intended and any such change is not expected to be material. There is also no intention to change the methodologies underlying the reserving for the SMI business following the Effective Date. However, as explained in paragraph 6.26, above, there will be a change in the reserving for SMI to allow for the change in SMI's case reserving philosophy for personal injury claims, which has been brought into line with that of NOE. I note that the methodologies in respect of all of the business will doubtless evolve over time as the business evolves and as particular reserving challenges emerge.

Conclusion

- 6.90 There will be no change in the strength of the reserves held post-Schemes by NOE in respect of the Transferring Business relative to the strength of the reserves held pre-Schemes by SMI in respect of the same business.

EXCESS ASSETS OF SMI

- 6.91 SMI monitors actual and projected solvency capital requirements on a global basis and also in Canada.
- 6.92 In assessing its SCR for regulatory purposes, SMI uses the standard formula provided by EIOPA. It has assessed the appropriateness of using the standard formula and has concluded that, overall, the standard formula leads to a higher valuation of risk than is reflected in SMI's own risk profile. This is not an unreasonable conclusion – as a small insurer, focusing on cover provided to the marine fishing industry, SMI is not directly comparable to the "average insurer" upon whose experience the EIOPA standard formula parameters have been based. That is not to say that the standard formula measures all of SMI's risk components conservatively, rather that its measure in totality is expected to be conservative.
- 6.93 For SMI's ORSA calculations, SMI has developed its own models that reflect the claims characteristics and reinsurance structure of its business.
- The stochastic capital models for premium risk and reserving risk have been developed using the ReMetrica platform. This model uses SMI's own claims history to set volatility assumptions and applies SMI's reinsurance programme explicitly to the gross claims modelling to capture net claims volatility.

- For other risks, the approach is to agree a known or expected valuation at a specific likelihood point and then to apply a statistical distribution to arrive at other likelihoods. Some risks facing SMI are not quantifiable using statistical or mathematical techniques. SMI has considered a range of scenarios, selected judgmentally, and their likely financial impacts in order to ensure that an appropriate estimate is made of the value of these risks at different likelihoods.
 - Correlation coefficient assumptions within the risk profile were set within the business by examining the key drivers of correlation between risk categories.
- 6.94 The standard formula SCR is at a 1 in 200 risk level on a one-year basis. SMI's own models are used to produce SCRs on a to-ultimate basis, at both a 1 in 200 and a 1 in 20 risk level (calculations at other likelihood levels are also performed when considered appropriate). 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 the assets backing the liabilities (with no need for a risk margin).
- 6.95 As mentioned at various points earlier in this Report, SMI benefits from a guarantee issued by its parent, NOE. This Parental Guarantee covers all obligations, including payments to policyholders and regulatory solvency requirements, and is unconditional, continuing and binding on NOE. No allowance is made in any of SMI's solvency calculations for the Parental Guarantee, although it is taken into account in the reverse stress testing within the ORSA.
- 6.96 The most significant components of SMI's regulatory SCR are insurance risk and counterparty default risk, each being 27% of the solvency capital requirement on a Solvency II basis, prior to application of diversification benefits, as at 20 February 2019. As at the same date, market risk is 22% and operational risk 4% of the undiversified solvency capital requirement over the same period.
- 6.97 Prior to the implementation of the flexible apportionment agreement between SMI and NOE, SMI carried significant pensions risk in respect of the SMI DB Scheme. Such risks included: (i) decreases in interest rates leading to increases in liability values; (ii) increases in longevity leading to increases in the cost of benefits; and (iii) inflation increases leading to increases in the cost of benefits. Pension risk is not explicitly modelled within the standard formula calculation of the SCR, although PRA guidance requires that a market risk asset charge is applied to scheme assets. Therefore, to recognise this limitation within the standard formula, SMI has included a capital add-on of US\$7.8 million within its SCR since the introduction of Solvency II. As discussed in paragraph 4.102, above, all of SMI's liabilities as the statutory employer for the SMI DB Scheme were transferred to NOE with effect from 1 February 2018 via a flexible apportionment agreement and, since that date, SMI has no longer been subject to any pensions-related risk. However, SMI was unable to release the capital add-on until it received explicit approval from the PRA, that permission being received on 8 March 2019. Therefore, SMI's SCR as at 20 February 2019 includes the capital add-on of US\$7.8 million, which has since been released.
- 6.98 The risks to SMI associated with Brexit have been mitigated somewhat by the establishment of North EU to write all of the North Group's non-UK EEA risks with effect from 20 February 2019 (other than that bound by Knighthood, which continued to be written by NOE). It is anticipated that a further Part VII transfer will be required, with the North Group's non-UK EEA business written prior to 20 February 2019 (plus that bound by Knighthood and written by NOE on 20 February 2019) being transferred to North EU. This is discussed in more detail in paragraphs 4.80 and 4.121, above.
- 6.99 I have reviewed the work undertaken in estimating capital requirements for SMI, as documented in the SMI report entitled *Own Risk and Solvency Assessment Report - December 2019*, 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 SMI's modelling team, the key assumptions employed, and the resulting capital amounts. Based on my review, I consider the methodology and modelling techniques used by SMI to be in line with industry practice and generally appropriate. As a result, I believe it is reasonable for me to rely on the work of the SMI modelling team, and, therefore, I have not attempted to review in detail the calculations performed by SMI in order to estimate its SCR.

- 6.100 SMI's QRTs as at 20 February 2019, as contained within SMI's SFCR 2019, indicate that SMI was then well-capitalised relative to its SCR, with a Capital Cover Ratio of 168%. Had the capital add-on been removed as at 20 February 2019, then SMI would have been deemed a very well-capitalised company, with a Capital Cover Ratio of 223%. I have seen SMI's QRTs as at 20 August 2019. These are not public documents so I cannot state their content in this Report but I note that they indicate that SMI was very well-capitalised as at 20 August 2019.
- 6.101 SMI's *Own Risk and Solvency Assessment Report - December 2019* shows that (on a standalone basis and ignoring the planned Schemes) the one-year time horizon Capital Cover Ratios for SMI are expected to increase from their level as at 20 August 2019 as the business generates increasing amounts of surplus. However, I note the comment, repeated several times within the aforementioned report, that the growth targets upon which SMI's business plan is predicated are ambitious. While SMI's management consider those targets to be achievable, they could be jeopardised by external factors, such as the shape of Brexit arrangements, that might affect the businesses of SMI policyholders and hence their own expansion plans.
- 6.102 The Capital Cover Ratios underlying the above analysis are on a statutory (standard formula) basis. The Capital Cover Ratios based on SMI's own assessment of its risks (to ultimate) are higher, reflecting SMI's view that the standard formula SCR is a prudent (albeit not unreasonable) measure of the underlying risk of its business.

Conclusion

- 6.103 I have explained above why I consider that SMI's calculations and projections of its solvency requirements and available capital, and hence of its excess assets, are reasonable. Overall, these lead me to conclude that the policyholders of SMI, including those who will transfer under the proposed Schemes, currently benefit from the financial strength provided by a very well-capitalised company.

EXCESS ASSETS OF NOE

- 6.104 NOE monitors actual and projected solvency capital requirements on a global basis and also across the following jurisdictions:
- Australasia;
 - Singapore;
 - Hong Kong; and
 - Japan.
- 6.105 In assessing its SCR for regulatory purposes, NOE uses the standard formula provided by EIOPA. It has assessed the appropriateness of using the standard formula and has concluded that, overall, the standard formula leads to a higher valuation of risk than is reflected in NOE's own risk profile. This is not an unreasonable conclusion – as a mutual insurer, focusing on primarily P&I and FDD business, NOE is not directly comparable to the "average insurer" upon whose experience the EIOPA standard formula parameters have been based. That is not to say that the standard formula measures all of NOE's risk components conservatively, rather that its measure in totality is conservative.
- 6.106 For its ORSA calculations, NOE has developed its own models that reflect the claims characteristics and reinsurance structure of its business.
- The stochastic capital models for premium risk and reserving risk have been developed using the ReMetrica platform. This model uses NOE's own claims history to set volatility assumptions and applies NOE's reinsurance programme explicitly to the gross claims modelling to capture net claims volatility.
 - For other risks, the approach is to agree a known or expected valuation at a specific likelihood point and then to apply a statistical distribution to arrive at other likelihoods. Some risks facing NOE are not quantifiable using statistical or mathematical techniques. NOE has considered a range of scenarios, selected judgmentally, and their likely financial impacts in order to ensure that an appropriate estimate is made of the value of these risks at different likelihoods.
 - Correlation coefficient assumptions within the risk profile were set within the business by examining the key drivers of correlation between risk categories.
- 6.107 The main differences between the standard formula SCR results and those assessed using NOE's own model are in respect of:

- **Market risk:** the standard formula is likely to overstate market risk in respect of NOE, specifically for concentration risk, given the generic formulaic nature of the standard formula compared to the specific analysis carried out by NOE, which currently uses economic scenario generator data provided by Mercers.
 - **Pension risk:** since the implementation of the flexible apportionment agreement between SMI and NOE, NOE has carried the risks associated with both the NOE DB Scheme and the SMI DB Scheme. These I explained in paragraph 6.97, above. Although pension scheme assets attract a market risk asset charge under the standard formula, the risk associated with pension liabilities is not explicitly covered. As such, the standard formula currently understates pension risk in respect of NOE. I discuss the issue of a capital add-on, relating to the pension risk, in paragraph 6.110, below.
 - **Operational risk:** The standard formula is likely to understate risk in respect of NOE, given its formulaic nature compared to the specific analysis carried out by NOE. Operational risks covered in NOE's model include four specific risks not separately valued by the standard formula: reputation risk, contagion risk, significant projects and legal environment risk. Significant project risk is currently the main driver in the valuation of the risk profile currently, as it accounts for a particular project by which legacy IT systems are being rationalised and replaced. This work is expected to be completed during 2020. It is expected that if this project is implemented successfully then there will be a significant reduction in the operational risk profile.
 - **Diversification benefit:** The standard formula is likely to be more prudent in respect of the diversification of risk when correlated compared to the specific analysis carried out by NOE.
- 6.108 The standard formula SCR is at a 1 in 200 risk level on a one-year basis. NOE's own models are used to produce SCRs on a to-ultimate basis, at both a 1 in 200 and a 1 in 20 risk level (and as at other levels, as appropriate). 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 the assets backing the liabilities (with no need for a risk margin).
- 6.109 As mentioned at various points earlier in this Report, NOE has provided a Parental Guarantee to SMI, covering all of SMI's obligations, including payments to policyholders and its regulatory solvency requirements, and is unconditional, continuing and binding on NOE. No allowance is made in any of NOE's solvency calculations for the Parental Guarantee, although, in the NOE ORSA report, stress and reverse stress tests are applied on a North Group basis.
- 6.110 As noted above, NOE also carries significant pension risk, arising from its obligations regarding the NOE DB Scheme and the SMI DB Scheme, and the SCR calculated using the standard formula does not allow explicitly for the liability risks of those schemes. To recognise this limitation within the standard formula, NOE included a capital add-on of US\$22.5 million within its SCR (prior to NOE assuming the risk for the SMI DB Scheme, the capital add-on was US\$14.7 million) as at 20 February 2019. The analysis underlying the calculation of the quantum of add-on for NOE (and for SMI) was performed in 2015 by a third-party firm of actuarial consultants. The North Group has provided me with a copy of a paper, dated 2 August 2018 and prepared by the same third-party firm of actuarial consultants, that updated that analysis, and which indicated a capital add-on that would be much reduced from that held to date by NOE (despite NOE accepting the liabilities associated with the SMI DB Scheme). Discussions between the PRA and NOE concluded that the revised capital add-on suggested by the aforementioned paper was not material to NOE. The North Group has since applied to the PRA to have the voluntary capital add-ons for both NOE and SMI removed. As noted in paragraph 6.97, above, that application was accepted by the PRA and the voluntary capital add-ons ceased to apply to either company, or to the North Group, with effect from 8 March 2019. However, the capital add-on of US\$22.5 million was still included within NOE's SCR as at 20 February 2019.
- 6.111 The most significant component of NOE's Solvency II SCR is market risk, being 45% of the solvency capital requirement, prior to application of diversification benefits, as at 20 February 2019. As at the same date, insurance risk, default risk and operational risk were 9%, 21% and 12% respectively of the undiversified solvency capital requirement. The remaining 12% of the SCR, prior to application of diversification benefits, was the capital add-on (since removed).

- 6.112 The risks associated with Brexit have been mitigated by the establishment of North EU to write all non-UK EEA risks on behalf of the North Group. As discussed in paragraphs 4.80, 4.121 and 6.98, above, the North Group anticipates a further Part VII transfer, to North EU, of its non-UK EEA risks written prior to 20 February 2019.
- 6.113 I have reviewed the work undertaken in estimating capital requirements for NOE, as documented in NOE's *Own Risk and Solvency Assessment Report - December 2019*, 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 NOE's modelling team, the key assumptions employed, and the resulting capital amounts. Based on my review, I consider the methodology and modelling techniques used by NOE to be in line with industry practice and generally appropriate. As a result, I believe it is reasonable for me to rely on the work of the NOE modelling team, and therefore I have not attempted to review in detail the calculations performed by NOE in order to estimate its SCR.
- 6.114 NOE's QRTs as at 20 February 2019, as contained within NOE's solo SFCR 2019, indicate that NOE was then well-capitalised relative to its SCR, with a Capital Cover Ratio of 182%. Had permission to remove the capital add-on been received prior to 20 February 2019, the SCR would have been reduced by US\$22.5 million and the Capital Cover Ratio would have been 213%, consistent with NOE then being a very well-capitalised insurer. I have seen NOE's QRTs as at 20 August 2019. These are not public documents so I cannot state their content in this Report but I note that they indicate that NOE was well-capitalised as at 20 August 2019, i.e. that the capital cover ratio had reduced from what it would have been six months earlier had the capital add-on then been removed. This reflects movements in both the eligible own funds and the SCR. The eligible own funds of NOE have reduced during the February-August period through an increase in the net technical provisions and an upwards revision of NOE's liabilities to the NOE DB Scheme and the SMI DB Scheme. The SCR (post release of the capital add-on) has increased over the same period, with increases in the market risk and counterparty default risk being only partially offset by reduced underwriting risk and greater diversification benefit.
- 6.115 The capital available to support the SCR falls into two categories: basic own funds (which comprises entirely Tier 1 capital); and ancillary own funds ("AOF", which is considered Tier 2 capital). AOFs are essentially off-balance sheet assets. The use of AOFs to support the SCR is restricted under Solvency II and is subject to regulatory approval. Within NOE, AOFs represent the ability of NOE to make additional premium calls on its members in the event of a shortfall. As agreed with the PRA, AOFs are valued as a percentage of members' P&I premiums, making allowance for default risk, and subject to a maximum value 50% of NOE's SCR. I note that, even without allowance for the AOF's, NOE was well-capitalised as at 20 February 2019, and more than sufficiently capitalised as at 20 August 2019.
- 6.116 NOE's *Own Risk and Solvency Assessment Report - December 2019* shows that (on a standalone basis and ignoring the planned Schemes) the one-year time horizon Capital Cover Ratios for NOE are expected to reduce from the level that they would have been as at 20 February 2019 had the capital add-on by then been released, consistent with the aforementioned fall in the Capital Cover Ratio between 20 February 2019 and 20 August 2019, and then to increase. Based on these projections, I consider it likely that NOE would be well-capitalised throughout the period to 20 February 2022, and very well capitalised as at both 20 February 2023 and 20 February 2024. I note that, even without allowance for the AOF's, I would expect NOE to be more than sufficiently capitalised throughout the period to 20 February 2022, and well-capitalised as at both 20 February 2023 and 20 February 2024.
- 6.117 The Capital Cover Ratios underlying the above analysis are on a statutory (standard formula) basis. I consider it very likely that the Capital Cover Ratios based on NOE's own assessment of its risks would have been higher.
- 6.118 In the event of an unexpected capital shortfall, NOE has stated that it would consider the following in order to restore its capital buffer:
- Disinvest from higher risk investment assets (e.g. corporate bonds);
 - Call for additional premium from its members by way of a supplementary call (i.e. utilise the AOFs);
 - Consider raising additional capital from third parties.

6.119 As NOE is the parent company of the North Group I have also considered the solvency requirements for NOE on a group basis. These indicate that, as at 20 February 2019, NOE (on a group basis) had an SCR of US\$145.9 million and available own funds including AOFs totalling US\$274.0 million. This leads to a Capital Cover Ratio of 188%, which indicates that NOE is well-capitalised relative to its SCR on a group basis as well as a solo entity. Had the capital add-on been released prior to 20 February 2019, the North Group's SCR would have reduced by US\$22.5 million and the Capital Cover Ratio would have increased to 224%, consistent with that of a very well-capitalised insurer. I have not seen equivalent figures as at 20 August 2019, but I consider it very likely that the Capital Cover Ratio would then have been such as to denote the North Group as a well-capitalised insurer. Projections indicate that, on the same basis, NOE (on a group basis) will be well-capitalised throughout the period to 20 February 2022, and very well capitalised as at both 20 February 2023 and 20 February 2024.

Conclusion

6.120 I have explained above why I consider that NOE's calculations and projections of its solvency requirements and available capital, and hence of its excess assets, are reasonable. Overall, these lead me to conclude that the policyholders of NOE, including those who will transfer under the proposed Schemes, currently benefit from the financial strength provided by a well-capitalised company.

EXCESS ASSETS OF NEMIA

6.121 As explained in paragraph 4.123, above, NEMIA is a Class 2 reinsurer. Class 2 insurers are required to maintain minimum capital and surplus (the Minimum Margin of Solvency or "MSM") of US\$250,000 – the MSM is an absolute floor for the required solvency capital of Bermuda-regulated insurer. Class 2 (re)insurers are subject to no other Bermudan solvency requirements.

6.122 As at 20 February 2019, on a UK GAAP basis, NEMIA's capital and surplus amounted to US\$214.8 million. This is equivalent to 40% of NEMIA's gross technical provisions (which are all attributable to NEMIA's quota share reinsurance of NOE).

6.123 I note that the underwriting component of NOE's SCR as at 20 February 2019 was US\$16.4 million. Had an SCR been estimated for NEMIA using the Solvency II standard formula, then the underwriting component would probably have been about US\$148.0 million (reflecting the fact that NEMIA's technical provisions comprise 90% reinsurance of most of NOE's business). The standard formula factors are calibrated to the 99.5th percentile over a one-year time horizon, which implies that NEMIA's capital and surplus would be more than adequate to withstand a 1:200 underwriting risk event. I also note that NOE has demonstrated that the standard formula loading in respect of underwriting risk is expected to be prudent, on both a one-year time horizon and on a to-ultimate basis. This gives me further comfort regarding the ability of NEMIA to still be able to meet its reinsurance obligations to NOE even in the event of severe deterioration in NOE's technical provisions.

6.124 Based on my review of NEMIA's balance sheet, I believe that the underwriting risk is the main risk to which NEMIA is exposed. I note that 85% of the investments (US\$647.0 million) are held in debt securities that are rated AAA, and the remainder (US\$115.8 million) in equity securities. The likelihood of the debt securities materially defaulting is very small. However, it is possible that the value of the equities could fall materially. I note that, were the technical reserves to increase by US\$148.0 million (as set out in paragraph 6.123, above) and were, at the same time, the value of the equities to reduce by US\$57.9 million (i.e. by 50%), NEMIA would still remain solvent (and compliant with the BMA's minimum solvency requirement). Both the aforementioned increase in technical provisions and fall in equity values are, in isolation, unlikely events, and thus the likelihood of them both happening at the same time is extremely remote. Therefore, I believe that the probability of NEMIA being unable to meet its obligations to NOE under the quota share reinsurance agreement is negligible.

6.125 The North Group has told me that there will be no change in the level of cover provided by NEMIA in respect of the Transferring Business post the Effective Date compared with that provided prior to application of the Schemes. Therefore, I do not expect the Schemes to have any effect on the financial strength of NEMIA.

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

- 6.126 I have concluded, above, that the Transferring Policyholders currently benefit from the financial strength provided by a very well-capitalised company. I have also concluded that, if the Schemes are implemented, the Transferring Policyholders will become policyholders of a well-capitalised company (whether considered on a solo or group basis, the latter remaining unaltered post the Effective Date from its values pre the Effective Date). Therefore, relative to the solvency capital requirements of the respective entities, the Transferring Policyholders will see a small decline in the financial strength afforded to them. However, I do not consider this decline in the financial strength to be material as the Capital Cover Ratio of NOE, post the Effective Date, indicates that the likelihood of the Transferring Policyholders not receiving the benefits to which they are entitled remains very small. I also note that the Transferring Policyholders will be moving from an insurance company with excess assets of about US\$48 million to a bigger company with excess assets of around US\$243 million.
- 6.127 The Transferring Policyholders currently benefit from both the quota share reinsurance contracts provided by NOE and the Parental Guarantee provided by NOE. This means that, currently, their security is indirectly dependent on the financial health of NOE. At the same time, the financial strength of NOE is heavily dependent upon the quota share reinsurance contract provided by NEMIA, so that, currently, the security of the Transferring Business is indirectly dependent on the financial health of NEMIA. Post the Effective Date, their financial security will be directly dependent on the financial health of NOE and will remain indirectly dependent on the financial health of NEMIA. In this respect, the Schemes will have had no material impact.
- 6.128 To illustrate the degree to which the financial security of the Transferring Policyholders might be adversely affected by the Schemes, I have undertaken a number of reverse stress tests, designed to illustrate how much adverse experience NOE (and NEMIA) would need to suffer post-Schemes before NOE would be unable to meet wholly its obligations to its policyholders, including the Transferring Policyholders.
- 6.129 For the sake of simplicity, I have undertaken these reverse stress tests based on the GAAP balance sheets as at 20 February 2019 (in the case of NOE, I have used the Ultimate Post-Scheme pro forma balance sheet, shown in Figure 5.2, above).
- 6.130 **Test 1:** deterioration in NEMIA's technical provisions: based on the UK GAAP accounts as at 20 February 2019, I have calculated that NEMIA's technical provisions could increase by up to 40% before the net assets of NEMIA fell to zero. Only when its net assets fell below zero would NEMIA be unable (without additional funding) to meet wholly its reinsurance obligations to NOE. In paragraph 6.134, below, I explain that the likelihood of NOE's technical provisions, net of NOE's excess of loss reinsurance programme, deteriorating by 50% is significantly less than 1 in 200. As NEMIA liabilities comprise only quota share reinsurance of NOE's liabilities, net of NOE's excess of loss reinsurance programme, a change in NOE's net technical provisions would result in a proportionately identical change in NEMIA's technical provisions. Thus, the likelihood of a 50% increase in NEMIA's technical provisions would be significantly less than 1 in 200. A 40% increase would be a less remote possibility but would still be a very unlikely event.
- 6.131 **Test 2:** deterioration in the value of NEMIA's investments: based on the UK GAAP accounts as at 20 February 2019, I have calculated that NEMIA's investments could fall in value by up to 28% before the net assets of NEMIA fell to zero. I note that 85% of NEMIA's investments are in the form of fixed interest securities, all rated BBB or better, with the remaining 15% in the form of equities. An overall fall of 28% in NEMIA's investments would equate to, say, a 60% reduction in the value of its equities and a 22% reduction in the value of its fixed interest securities. Taking as a benchmark the 2008 financial crash, at its most extreme the Dow Jones Industrial Average index fell by 54% (between October 2007 and March 2009) so, assuming that there is not material concentration risk in the equities, a 60% reduction in the value of equities would appear an extreme movement. I have been told by the North Group that its modelling of NEMIA's assets (as part of the ORSA exercise for NOE) indicated that a 22% fall in the value of its fixed interest securities would be an extremely remote outcome.

- 6.132 **Test 3:** deterioration in NOE's net technical provisions (and hence those of NEMIA): based on the UK GAAP accounts as at 20 February 2019, I have calculated that NOE's net technical provisions could increase by about 80% before the accumulated surplus of NOE fell to zero. In calculating this, I have assumed that the net technical provisions within NEMIA would increase by a similar proportion and that, as a result, NOE would be unable to recover less than 60 cents in the dollar in respect of the quota share reinsurance cover provided by NEMIA. Because NOE is protected by its Excess of Loss reinsurance programme (which applies prior to application of the quota share arrangement with NEMIA and which hence also protects NEMIA), an increase NOE's net technical provisions is likely to be exceeded by the corresponding increase in NOE's gross technical provisions. I have reviewed calculations performed by the North Group that indicate that it would expect an 80% increase in net technical provisions to equate to an increase of roughly 100% in gross technical provisions (the actual amount will depend on the extent to which movements in claim values relate to claims that already exceed or are close to the Excess of Loss retention levels).
- 6.133 **Test 4:** combination of deterioration in NOE's net technical provisions (and hence those of NEMIA) and fall in value of investments in both NOE and NEMIA. Based on the UK GAAP accounts as at 20 February 2019, I have calculated that NOE's accumulated surplus would fall to zero were its net technical provisions (and hence those of NEMIA) to increase by about 50% and the value of its investments and those of NEMIA to reduce by 20% (I note that, on a look-through basis, NOE's investments are weighted similarly to those of NEMIA, comprising predominantly fixed interest securities with a small proportion of equities, property, etc.). Clearly, other combinations of percentage falls in investment values and increases in technical provisions could produce the same outcome but this provides suitable illustration of the magnitude of the movement that is required to achieve the insolvency of NOE.
- 6.134 Both a 50% increase in NOE's net technical provisions and a 20% reduction in the value of its investments would be extreme outcomes, individually and especially as a combination.
- The potential for material deterioration on large claims is mitigated by NOE's excess of loss reinsurance programme. The likelihood of the technical provisions deteriorating by 50%, net of the excess of loss reinsurance programme, is extremely small, estimated to be significantly less than 1 in 200.
 - It is possible that a lesser increase in the technical provisions, gross of reinsurance, could trigger the insolvency of NOE if it were in combination with the (partial) failure of NOE's excess of loss reinsurance programme. Leaving aside the cover provided through the International Group pool (which I consider below), a complete and absolute failure of the excess of loss reinsurance programme would increase NOE's technical provisions as at 20 February 2019 by about 35%. As noted in paragraph 4.61, above, as at 20 February 2019 96% of NOE's reinsurance programme (excluding that provided by NEMIA) was provided by reinsurers rated 'A' or better by Standard and Poor's. The programme is also well diversified with cover provided by some 50 different carriers. The likelihood of some of these carriers will become insolvent is not immaterial but the likelihood that this would result in a material part of NOE's ceded technical provisions being unrecoverable is very remote, and would probably involve a major systemic failure within the worldwide insurance market.
 - The international Group fulfils a significant role in NOE's risk mitigation strategy through its risk pooling arrangements. Were the pool to be dissolved then NOE would have to absorb the excess cost of its outstanding claims that currently are covered by the pool. However, I note that, as a member of the pool, NOE also has to meet its share of the excess of the covered claims of the other pool members and that, as at 20 February 2019, NOE's share of the pooled liabilities exceeded its expected recoveries. I understand that the position has since remained unchanged up to the date of the most recently calculated pool accounts. Therefore, were the International Group pool to be dissolved, it is likely to have a positive impact on NOE's balance sheet (based on its balance sheet as at 20 February 2019). However, I note that, should the International Group pool to be dissolved, the insurance risk within NOE would be increased unless NOE were able to replace, via the reinsurance market, the cover hitherto provided by the pool. Such cover might prove hard to find and costly.

- In paragraph 6.131, I explained that the 28% reduction in the value of NEMIA's investments that (in isolation) would be sufficient to cause NEMIA's insolvency was highly unlikely due to the composition of NEMIA's invested assets. That remains the case for the lesser reduction of 20%. I note that, in its ORSA, NOE has considered the impact of a market-turning event, namely a global downturn, leading to a 30% fall in equity values, 40% fall in property values, interest rate spot curves falling 100 basis points, and credit spreads increase on all non-sovereign bonds by 150-400 basis points, depending on their quality. However, the modelled impact of this extreme event upon NEMIA's investment portfolio was to reduce it by less than 7%. A larger fall is possible but it would need to be combined with another material adverse event, such as a significant theft from the bank accounts of NOE and/or NEMIA.

Conclusion

- 6.135 While the Transferring Policyholders will be moving to an insurer (NOE) with a lower Capital Cover Ratio than that of the insurer (SMI) that they will be leaving, I consider that the likelihood that the capital cover provided by NOE will prove to be insufficient is very small, as evidenced by the reverse stress tests conducted above. Therefore, I am therefore satisfied that the Transferring Policyholders will not be materially adversely affected due to relative differences in the financial strength of NOE post-Schemes to those of SMI pre-Schemes.

IN THE EVENT OF INSOLVENCY

- 6.136 Pre-Schemes, were it to become insolvent, SMI would be able to call upon the Parental Guarantee to make good any shortfall in its solvency position. Under the terms of the Parental Guarantee, NOE is obliged to provide this support up to the point where NOE itself would become absolutely insolvent, even after calling on its members for additional premiums (up to the limit in its contracts). Therefore, it would take the effective insolvency of both SMI (pre-application of the Parental Guarantee) and NOE (denoted by the exhaustion of the Parental Guarantee) for the Transferring Policyholders not to have their claims paid in full by SMI. I note that, if NOE were insolvent and under the terms of the Parental Guarantee, the direct policyholders of SMI would rank alongside the direct policyholders of NOE. The cedant policyholders of SMI would rank alongside the cedant policyholders of NOE, behind the direct policyholders of SMI and NOE as well as behind holders of NOE preferential debt.
- 6.137 Pre-Schemes, were NOE to become insolvent but SMI were not to become insolvent at the same time, the Transferring Policyholders would continue to have their claims paid by SMI. Through the quota share reinsurance as at 20 February 2019, NOE provides SMI's balance sheet with assets totalling US\$28.4 million, which is equivalent to 54% of the own funds available to meet SMI's SCR. SMI will not benefit from that asset until NOE's preferential debt has been repaid and claims liabilities in respect of all direct NOE policyholders have been met fully. Even then, SMI will benefit only proportionally, along with other remaining creditors. Depending on the scale of insolvency within NOE, this could mean that the reinsurance asset within SMI's balance sheet is heavily compromised, which in turn could jeopardise SMI's own solvency and the security of SMI's policyholders.
- 6.138 Post-Schemes, were NOE to become insolvent, those Transferring Policyholders who were direct policyholders would rank alongside the direct policyholders of NOE, behind holders of preferential debt but ahead of other creditors, including cedant holders of reinsurance contracts with NOE. Transferring Policyholders who were themselves cedants would rank alongside cedant holders of reinsurance contracts with NOE.
- 6.139 The extent to which the Transferring Policyholders would be better off post the Effective Date than they would have been pre the Effective Date in the event of circumstances that would have caused the insolvency of SMI and/or NOE depends on the impact of those circumstances and on their status as direct policyholders or cedants.
- 6.140 Pre-Schemes, the Capital Cover Ratios indicate that both SMI and NOE are unlikely to become insolvent (SMI the more so). Post-Schemes, the Capital Cover Ratios indicate that NOE is still unlikely to become insolvent.

Conclusion

6.141 It is possible that, in the event of the insolvency of NOE and depending on the precise circumstances of the insolvency, the Transferring Policyholders would be in a worse position post-Schemes than they would have been pre-Schemes. However, I consider the likelihood of the incidence of such circumstances whereby the Transferring Policyholders would be in a worse position to be remote. Therefore, I am satisfied that the Transferring Policyholders will not be materially adversely affected due to relative differences in their rights pre- and post-Schemes in the event of the insolvency of NOE.

CHANGES IN RISK EXPOSURES

6.142 If the Schemes are sanctioned, the Transferring Policyholders will no longer be exposed to the risks within SMI, but will be exposed to those of NOE. These policyholders are already indirectly exposed, to some extent, to part of the risk exposure of NOE through NOE's quota share reinsurance of the Transferring Business – the NOE reinsurance asset held in SMI's balance sheet as at 20 February 2019 represents 204% of the surplus of the eligible own funds available to meet the SCR over the SCR itself. Therefore, a complete failure of this asset would leave SMI as an insufficiently capitalised insurer and would thus significantly increase the likelihood that SMI would be unable to meet its liability payments in respect of the Transferring Business.

6.143 The Transferring Policyholders are also currently exposed to the risks within NOE via the Parental Guarantee.

6.144 While the Boards of NOE and SMI have been able to set their own risk appetite statements, they are expected to be consistent with the risk appetite of the North Group. Although there are differences between the risk exposures in NOE relative to those in SMI, in particular relating to the types of business written, overall they are governed and managed similarly, and similar risk mitigation actions have been taken in both entities.

6.145 However, different risk profiles, insofar as they might affect the future financial security of policyholders, are reflected in the capital requirements of SMI and NOE. As I have already concluded, NOE is currently a well-capitalised company (and is projected to remain so post the Effective Date) and SMI is a very well-capitalised company. Therefore, I am satisfied that, even were the Schemes to result in adverse change to the Transferring Policyholders' risk exposures, the capital protection available to them post-Schemes (while reduced) will not be materially different to that which they enjoyed pre-Schemes. Therefore, I conclude that any change in their risk exposure will not have a materially adverse impact on the security of the Transferring Policyholders.

6.146 There is also a further potential benefit to the Transferring Policyholders in that, as explained in paragraph 5.11, above, the North Group believes that the Schemes (and the subsequent dissolution of SMI) will result in considerable cost savings in relation to corporate governance, auditing, compliance, management and other costs that are currently duplicated within NOE and SMI as separate legal entities. Over time, all other things being equal, this will strengthen the balance sheet of the combined entity, thus improving the security of the Transferring Policyholders.

Conclusion

6.147 I am satisfied that, although the proposed Schemes will lead to some change to the risk exposures of the Transferring Business, this will not have a materially adverse impact on the security of the Transferring Policyholders' benefits.

POLICY SERVICING

6.148 There should be no change to the policy administration arrangements of the Transferring Business as a result of the Schemes. NGSL has assumed all employees of SMI, including those responsible for policy servicing, and NGSL's employees now perform all policy administration and servicing (other than the administration of claims in respect of the business of SMI's branch in Canada), as managed by SMI. There are no planned changes, post-Schemes, to the services standards, policy management and administration practices, processes or procedures, or to the NGSL employees performing the policy administration and servicing.

- 6.149 It is also intended that NGSL employees will continue to operate the existing administration systems (subject to the on-going project to rationalise and, where appropriate, replace legacy systems). Therefore, there will be no change in this respect for the Transferring Business.
- 6.150 On and from the Effective Date, NOE shall become the sole data controller (as opposed to the joint controller) of any personal data that relates to the Transferring Business. As such, NOE shall owe to the Transferring Policyholders, and to any other person, the same duties of confidentiality and privacy both prior to and from the Effective Date.

Conclusion

- 6.151 Because there are no intended post-Schemes changes to the policy administration arrangements, the policy administration systems or the policy administration personnel, I believe that neither the Scheme nor the Jersey Scheme will have a materially adverse impact on the standards of policy servicing experienced by the Transferring Policyholders compared to their current position.

BREXIT

- 6.152 I have discussed Brexit and the North Group's plans to deal with it in several places earlier in this Report. These issues and plans will be unaffected by the Schemes.
- 6.153 The North Group has determined that its existing business will be classified as either "non-UK EEA" or "other" based on the place of management.
- 6.154 Post Brexit, SMI and NOE would continue to be regulated by the PRA and FCA. Brexit would not affect this.
- 6.155 I note that the Scheme will transfer the non-UK EEA business within SMI to NOE, and that, subsequently and as set out in paragraph 5.15, above, the North Group is planning to transfer the Legacy EEA Business (including that transferred from SMI as a result of the Scheme) from NOE to North EU (the Brexit Part VII), although the decision whether or not to proceed with the Brexit Part VII depends on various as yet unresolved factors. Should it proceed, the Brexit Part VII would be subject to separate consideration by the Court. I have not considered the implications of this further because:
- it would be the duty of the Court, supported by the Independent Expert who had been appointed by the North Group in relation to the Brexit Part VII, to consider the implications of that scheme upon the various groups of policyholders, which would include holders of non-UK EEA business transferred from SMI to NOE and which in totality would comprise two of the three groups of policyholders whom I have considered in this report, namely the Transferring Policyholders and the current policyholders of NOE; and
 - the North Group has told me that SMI policyholders with non-UK EEA business will be in no different position if the Scheme is approved than they are currently, as, in such circumstances, it would intend to include SMI alongside NOE as a transferor in the Brexit Part VII, should the North Group decide to proceed with the Brexit Part VII.

Effect on balance sheets

- 6.156 Immediately following the referendum, the value of sterling on the currency exchange market dropped sharply and continued to fall throughout the summer of 2016. This was largely balanced by rises in the UK equity market, partially fuelled by much of the revenue for many large FTSE companies being in currencies other than sterling, which produced higher than expected levels of revenue in sterling-denominated profit & loss accounts due to the weaker value of sterling.
- 6.157 It is unclear what will happen to sterling and to UK asset values following Brexit itself. While the transition period should provide a basis for stability, it is likely that there will be some volatility while trade deals are negotiated. Any such instability would affect the balance sheets of companies with assets and/or liabilities in multiple currencies including sterling, although the impact for NOE and SMI would be mitigated by the policy of matching of assets and liabilities by currency.

Conclusion

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

CONCLUSION FOR THE TRANSFERRING POLICYHOLDERS

6.159 I am satisfied that neither the Scheme nor the Jersey Scheme will affect in a materially adverse way either the security or the policy servicing levels of the Transferring Policyholders.

7. THE IMPACT OF THE SCHEMES ON THE HOLDERS OF RESIDUAL POLICIES

- 7.1 In this section of the Report, I consider the impact of the Schemes on those SMI policyholders whose policies will not be transferred to NOE but who therefore will remain SMI policyholders after the Effective Date, i.e. the holders of Residual Policies.
- 7.2 As noted in paragraph 5.38, above, it is intended that there will be no Residual Policies (although it is accepted that, should the Canada Assumption Reinsurance not be effected on or before the Effective Date, the hull and liability policies written by SMI's Canadian branch will be Residual Policies). The Companies shall work towards transferring each and every Residual Policy (except those hull and liability policies written by SMI's Canadian branch) to NOE, by novation or by other means. Should the hull and liability policies written by SMI's Canadian branch be Residual Policies, the North Group would continue to work towards the implementation of the Canada Assumption Reinsurance while also running off those policies.
- 7.3 Post the Effective Date, the liability side of SMI's balance sheet would be almost empty, save for accumulated surplus roughly equal to the SCR and the gross of reinsurance liabilities associated with any Residual Policies. Under the Schemes, post the Effective Date, any and all Residual Policies (except those hull and liability policies written by SMI's Canadian branch) will be fully reinsured by NOE, for no further consideration. Therefore, the asset side of the balance sheet shall include, as "reinsurers' share of technical provisions", an amount equal to the gross of reinsurance liabilities of the Residual Policies, less the net liability relating to the hull and liability policies written by SMI's Canadian branch.
- 7.4 Unless the liabilities associated with the Residual Policies are material (and they are not expected to be so) then the SCR is expected to be equal to the level of the MCR, which would then be at, or close to, its floor level of €3.7 million (roughly US\$4 million). At that point, the Capital Cover Ratio would be at 100%, which would be much reduced from its level pre-Schemes. On the other hand, the net of reinsurance liabilities of the Residual Policies (except those hull and liability policies written by SMI's Canadian branch) would be nil, the liabilities being wholly reinsured by NOE. Therefore, the security of the benefits of any holders of Residual Policies (except those hull and liability policies written by SMI's Canadian branch) would be dependent on the financial health of NOE. As such, they would be in a similar position to the holders of policies that were transferred. As I explained in paragraph 6.135, above, I believe that holders of policies that were transferred will not be materially adversely affected by relative differences in the financial strength of NOE post-Schemes to those of SMI pre-Schemes, and I similarly believe that holders of Residual Policies will similarly not be materially adversely affected.
- 7.5 Pre-Schemes, were NOE to become insolvent but SMI not to become insolvent at the same time, the Transferring Policyholders would continue to have their claims paid by SMI, as appropriate. However, SMI would be unable to call upon the Parental Guarantee were there to be any shortfall in its accounts. Furthermore, as a cedant to NOE, which provides quota share reinsurance to SMI, SMI would rank behind the direct policyholders of NOE, as well as behind holders of preferential debt. Through the quota share reinsurance as at 20 February 2019, NOE provides SMI's balance sheet with assets totalling US\$28.4 million, which is 54% of the own funds available to meet SMI's SCR and which, if this reinsurance asset were wholly unavailable, would leave SMI insufficiently capitalised and at risk of not meeting the outstanding liabilities of its policyholders. Post-Schemes, SMI would continue to rank behind the direct policyholders of NOE, as well as behind holders of preferential debt, but (unless the liabilities associated with the Residual Policies are material) SMI is likely to be able to meet the outstanding liabilities in respect of the Residual Policies because the size of the retained surplus is likely to exceed any shortfall in the performance of the 100% reinsurance provided by NOE.
- 7.6 While Brexit might affect the holders of Residual Policies, I do not believe that it would exacerbate, to any material degree, the impact on them of the Schemes.
- 7.7 The Residual Policies will be treated by NOE no less favourably than they would be had they been transferred as part of the Schemes.
- 7.8 It is intended that the Parental Guarantee and reinsurance that currently exist between NOE and SMI will remain in place post-Schemes to cover any unanticipated residual liabilities, but will become largely superfluous as a result of the Schemes.

CONCLUSION FOR THE POLICYHOLDERS OF SMI NOT TRANSFERRING UNDER THE SCHEMES

- 7.9 I am satisfied that the security of the contractual rights or the standards of policy servicing currently enjoyed by policyholders of SMI who have Residual Policies would not be adversely affected by the Schemes.

8. THE IMPACT OF THE SCHEMES ON THE EXISTING NOE POLICYHOLDERS

8.1 In this Section, I consider the impact of the Schemes on the existing policyholders of NOE.

RELATIVE FINANCIAL STRENGTH ENJOYED BY THE EXISTING NOE POLICYHOLDERS PRE- AND POST-SCHEME

8.2 I have concluded, above, that the existing NOE policyholders currently benefit from the financial strength provided by a well-capitalised company. This is on both a solo and a group basis (i.e. including NOE's subsidiary, SMI), the latter remaining unaltered post the Effective Date from its values pre the Effective Date. Therefore, the existing NOE policyholders will see no material difference in the financial strength afforded to them.

8.3 It is expected that the Capital Cover Ratio for NOE will increase marginally over the period to 20 February 2023, subject to NOE meeting its business plan targets, but NOE is expected to remain a well-capitalised company throughout the period.

Conclusion

8.4 I am therefore satisfied that the existing policyholders of NOE will not be materially adversely affected due to relative differences in the financial strength of NOE pre-Schemes and post-Schemes.

IN THE EVENT OF INSOLVENCY

8.5 Pre-Schemes, in the unlikely event that were SMI to become insolvent, NOE would be obliged under the Parental Guarantee to make good any shortfall in SMI's solvency position. Under the terms of the Parental Guarantee NOE would be obliged to provide this support up to the point where NOE itself would become insolvent.

8.6 Pre-Schemes, in the unlikely event that were NOE to become insolvent but SMI not to become insolvent at the same time, the existing policyholders of NOE would rank ahead of SMI (which would be seeking payments in respect of the quota share reinsurance contracts with NOE) in accessing the remaining assets of NOE. However, if the insolvency of NOE and the inability of NOE to meet its reinsurance obligations resulted in the insolvency of SMI then under the Parental Guarantee the SMI policyholders would rank alongside NOE's own policyholders.

8.7 Post-Schemes, in the unlikely event that were NOE to become insolvent, the existing policyholders of NOE would rank alongside the Transferring Policyholders. In such circumstances, it is possible to argue that the existing policyholders of NOE would be disadvantaged by the Schemes. However, the extent to which the existing policyholders of NOE would be better off post the Effective Date than they would have been pre the Effective Date in the event of insolvency depends on the circumstances that caused the insolvency and the extent of the insolvency. For example, were the cause of the insolvency severe adverse development within the former SMI business then the effect on existing policyholders of NOE post-Schemes would be the same as it would have been pre-Schemes due to the application pre-Schemes of the Parental Guarantee.

8.8 Pre-Schemes, the Capital Cover Ratios indicate that SMI is unlikely to become insolvent and NOE is very unlikely to become insolvent. Post-Schemes, the Capital Cover Ratios indicate that NOE is very unlikely to become insolvent.

Conclusion

8.9 Although it is possible that the existing NOE policyholders might be in a worse position post-Schemes than they would have been pre-Schemes in the event of the insolvency of NOE, the very small likelihood of NOE becoming insolvent post-Schemes satisfies me that the existing NOE policyholders will not be materially adversely affected due to relative differences in their rights pre- and post-Schemes in the event of the insolvency of NOE.

CHANGES IN RISK EXPOSURES

- 8.10 Due to the existing Parental Guarantee, NOE is already exposed to the risks within SMI, albeit indirectly, and the transfer to NOE of SMI's assets and liabilities simply makes direct that exposure. Both pre and post-Schemes, any shortfall in the funding of SMI's liabilities would ultimately be met from the surplus assets of NOE and, in highly exceptional circumstances where NOE's surplus assets are also insufficient, by way of a supplementary call to NOE's mutual members.

Conclusion

- 8.11 I am satisfied that neither the Scheme nor the Jersey Scheme will lead to a change to the risk exposures of the existing policyholders of NOE.

EFFECT ON MEMBERS

- 8.12 SUP 18.2.38 requires that I describe the effect of the Scheme on the proprietary rights of the members of NOE, including the significance of any loss or dilution of the rights of those members to secure or prevent further changes that could affect their entitlements as policyholders. I should also consider and comment on the appropriateness of any compensation paid under the Scheme to members for any diminution of proprietary rights.
- 8.13 The business being transferred into NOE by the Schemes will be fixed premium business and the transferring policyholders (and the policyholders of business subsequently written under the "Sunderland Marine" label) will not be members of NOE. Therefore, there will, as a result of the Schemes, be no loss or dilution of the constitutional rights to which existing members of NOE are currently entitled, including but not limited to their entitlements and obligations as policyholders. While I note that fixed premium business could expose the existing members to a greater risk of there being calls upon them for additional premiums, I also note that the Parental Guarantee means that NOE's members are already exposed to this risk. Therefore, I believe there to be no need for existing members of NOE to receive any compensation on completion of the Schemes.

Conclusion

- 8.14 I am satisfied that neither the Scheme nor the Jersey Scheme will have any effect on the rights of existing members of NOE to secure or prevent further changes that could affect their entitlements as policyholders.

POLICY SERVICING

- 8.15 There should be no change to the policy administration arrangements in respect of the existing NOE business as a result of the Schemes. As explained in paragraph 6.148, above, the Companies have retained responsibility for all policy management and administration but have engaged NGSL employees to perform the policy administration and servicing tasks. Those arrangements will remain in place, post the Effective Date, subject to the same services standards, with the same staff and with the same policy management and administration practices, processes or procedures as they are currently.

Conclusion

- 8.16 I believe that the neither the Scheme nor the Jersey Scheme will have a materially adverse impact on the standards of policy servicing experienced by the existing NOE policyholders compared to their current position.

BREXIT

- 8.17 As discussed in paragraphs 6.152-6.158, above, I believe that the Brexit issues that affect NOE will be unaffected by the Schemes.

Conclusion

- 8.18 I do not believe that Brexit will materially alter the expected effects (if any) of the proposed Schemes on the security of the benefits or the standards of policy servicing experienced by the existing NOE policyholders.

CONCLUSION FOR THE EXISTING NOE POLICYHOLDERS

- 8.19 I am satisfied that neither the Scheme nor the Jersey Scheme will affect in a materially adverse way either the security, membership rights or the policy servicing levels of the existing NOE policyholders.

9. OTHER CONSIDERATIONS

ASSETS OF SMI AND NOE

- 9.1 Ultimately, the transferring assets are expected to be all of the assets of SMI including the benefit of those reinsurance contracts and other third party contracts, reinsurance recoveries, salvage and subrogation rights and the books and records, all as pertaining to the Transferring Business. As explained in paragraph 5.46, above, immediately post the Effective Date, SMI will be required to hold reserves in respect of the Residual Policies (if any) and also to maintain solvency capital, in accordance with the requirements of both OSFI and the PRA. That capital can only be released and transferred to NOE with the permission of OSFI and the PRA when all remaining liabilities have been novated, reinsured or otherwise fully discharged.
- 9.2 The book value of SMI is already included within the NOE IFRS balance sheet as an investment holding in a group related entity. The nature of the investment assets being transferred should be consistent with those already within NOE as both NOE and SMI are subject to the same North Group investment policy.

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

- 9.3 In this Report I have shown balance sheet data for SMI and NOE as at 20 February 2019 (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 20 February 2019, but which include data, as at 20 February 2019, that relates to subsequent transactions, such as the Schemes.
- 9.4 I expect that the current activities of both NOE and SMI have continued, and will continue, between 20 February 2019 and the Effective Date (and beyond in the case of NOE). Both NOE and SMI have continued, and will continue until the Effective Date (and beyond in the case of NOE), to write new business, and have continued, and will continue until the Effective Date, 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.
- 9.5 I note that the North Group has provided to me a copy of its Directors' Report for the period ending 31 December 2019. This indicates that, overall and as at 31 December 2019, the North Group was forecasting a slightly better than planned result for the year ending 20 February 2020. The variance from plan is composed of a several items that are currently forecast to exceed or undershoot their planned values. However, I have seen nothing in the figures within the aforementioned Directors' Report that have given me cause to reconsider the conclusions that I have derived within this Report that were based on information as at earlier dates.
- 9.6 I believe that it is unlikely that any events occurring between 20 February 2019 and the Effective Date would affect any conclusion that I have reached based on my review as at 20 February 2019.
- 9.7 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 20 February 2019). I will then consider 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

- 9.8 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."* SMI is unaware of any actual or potential mis-selling liabilities within its respective business. 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. Therefore, I consider the likelihood of any mis-selling liabilities emerging in relation to the Transferring Business to be 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 Schemes will transfer any such liabilities, should they arise in relation to the Transferring Business, from SMI to NOE. I have not considered it necessary to comment further on this matter in this Report.

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

- 9.9 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.
- 9.10 Leaving aside the quota share reinsurance of part of the Transferring Business by NOE, all reinsurance contracts benefiting the Transferring Business will transfer under the Schemes. As at 20 February 2019, the external reinsurers' share of SMI's technical provisions amounted to approximately US\$21.7 million.
- 9.11 The amount of the liabilities of each external reinsurer of the Transferring Business will not change as a result of the Scheme.
- 9.12 As noted in paragraph 1.13, above, the staff who currently administer the Transferring Business (together with the relevant systems, records, etc.) are employed by NGSL and will continue to administer the Transferring Business, including dealing with recoveries under the relevant reinsurance programmes. This is expected to take place well before the Effective Date of the Schemes, and I have no reason to expect it to result in any change in the standards of claims handling or management. As the same staff will continue, post-Scheme, to administer the Transferring Business, operating to the same policies, processes, practices and procedures, I believe that the magnitude and timing of recoveries claimed against reinsurance contracts relating to the Transferring Business will be unaffected by the Schemes.
- 9.13 I have considered whether the Schemes are likely to lead to any changes in the rights of "set-off"³⁷ for creditors or debtors of SMI or NOE. The Transferring Business comprises inwards (re)insurance contracts mitigated by outwards reinsurance contracts. Any mutual debits or mutual credits relating solely to the Transferring Business would be available, post-Schemes, to NOE, but any that existed in SMI where one side only related to the Transferring Business would be lost. I have been told that the amount of set-off within SMI that would be lost as a result of the Schemes is small. This would only be an issue were SMI, post-Schemes, to become insolvent. As explained above, it is intended that no liabilities remain post-Schemes in SMI and that SMI be wound up as soon as possible, subject to PRA approval. Should any Residual Policies remain within SMI then this might become an issue. However, I consider the likelihood of SMI becoming insolvent, post-Schemes, to be remote. As such, I do not believe the right of set-off affects my conclusions on the impact of the Schemes on reinsurers.

Conclusion for the reinsurers of SMI whose contracts of reinsurance are to be transferred by the Schemes

- 9.14 For the reasons discussed above, I am satisfied that the Schemes will not have a materially adverse effect on the reinsurers of SMI whose contracts of reinsurance are to be transferred by the Schemes.

³⁷ "Set-off" allows parties to cancel or offset mutual debts with each other by subtracting one from the other, and paying only the balance.

THE APPROACH TO COMMUNICATION WITH POLICYHOLDERS

- 9.15 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 paragraph 2.53 of the Policy Statement, paragraph 2.46G of SUP18 and Sections 7 and 8 of FG18/4, the Companies would be expected to notify the policyholders, or interested persons (which would include all reinsurers of the business to be transferred), at least six weeks before the date of the Court hearing at which the application to sanction the Scheme will be heard.
- 9.16 The Companies' approach to communicating the Scheme to affected policyholders is outlined in paragraphs 5.53-5.63, above.
- 9.17 I consider the approach being taken to those Transferring Policyholders and reinsurers that SMI intends contacting directly, as well to those claimants and existing NOE policyholders that NOE intends contacting indirectly, to be reasonable.
- 9.18 I consider it reasonable that the Companies will be applying to the Court for waivers in respect of the requirement to make direct notification to the following groups:
- Those members of NOE's closed policy years who do not have outstanding claims against NOE. Policy years are only closed when it is considered highly unlikely that further claims will be reported. Therefore it is not expected that holders of policies in respect of closed years who do not have outstanding claims will have any remaining interest in their contracts for those years. I understand that NOE (and SMI) have a high proportion of policyholders who renew in successive years so many of those policyholders (at least in respect of recently closed years) are likely to be informed in the capacity of being policyholders in respect of open years;
 - Those Transferring Policyholders whose Transferring Policies were underwritten by SMI more than three years ago and who do not have open claims. The notification patterns for SMI claims indicate that very few are reported more than three years after the policy year;
 - Those Australian and New Zealand branch policyholders and US surplus lines policyholders whose policies were transferred from SMI and who were informed at the time of those transfers that such transfers formed part of the integration of SMI's business into NOE;
 - Those reinsurers with reinsurance agreements relating to the Transferring Business but who have not entered into an outwards reinsurance policy with SMI within the last three policy years and against whom SMI has no outstanding claims. This is consistent with the approach taken to communicating with SMI's policyholders, that no new claims are expected to be reported more than three years after the policy year and that no claim already notified will further develop more than three years after the policy year to the extent that it triggers a new notification to SMI's reinsurers.
- 9.19 I note that, while the Companies will use their own efforts to find alternate addresses for policyholder notifications that are returned as "delivery failure", they do not propose to instruct a third party tracing agent to locate policyholders that they cannot locate themselves. They argue that such a step would be unnecessary as they undertook a similar notification exercise less than five years ago, which resulted in very few undelivered notifications, all of which related to organisations which had been subsequently dissolved or had otherwise ceased business. Moreover, the inclusion of notices in newspapers and relevant industry publications would provide a pragmatic approach to notifying those who could not be contacted directly. I consider this to be a reasonable approach.
- 9.20 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.
- 9.21 I am satisfied that the proposed approach to communication with policyholders in respect of the Schemes is both proportionate and reasonable.

POLICYHOLDER EXPECTATIONS

- 9.22 I have not considered the expectations of policyholders other than whether their policies will continue to be serviced post-Schemes to the same service levels as they were pre-Scheme and the relative likelihood pre- and post-Schemes that they will receive whatever benefits to which they are contractually entitled. For example, I have not considered the reasons that SMI policyholders might have had in selecting SMI as their insurance provider and whether the Schemes would affect those reasons. However, I note that the Transferring Business comprises predominantly commercial risks and that no annuity business is involved. I have no reason to suspect that policyholders' expectations would (reasonably) be adversely affected to a material extent.

WHAT WOULD HAPPEN WERE THE SCHEMES NOT TO PROCEED?

- 9.23 In the event that the Scheme does not proceed then the Jersey Scheme would also not proceed and (were no alternative agreed to by the Companies) the status quo would be maintained. The Transferring Policyholders would continue to be policyholders of SMI, and SMI would continue to benefit from the Parental Guarantee provided by NOE (as well as the quota share reinsurance). I have concluded above that the Transferring Policyholders currently benefit from the financial strength afforded by a very well-capitalised company and would continue to do so if the Scheme were not to proceed, subject to SMI achieving the ambitious targets in its business plan (see paragraph 6.101, above).
- 9.24 While the Jersey Scheme will not proceed if the Scheme does not proceed, the Scheme would proceed even were the Jersey Scheme not to be sanctioned by the Jersey Court. In such circumstances, the Transferring Jersey Policyholders would become holders of Residual Policies. I have considered the implications of the Scheme for holders of Residual Policies in Section 7, above.
- 9.25 I do not believe that any group of policyholders would be adversely affected if the Scheme were not to proceed. However, the strategic plan of the North Group includes achieving cost savings through eliminating unnecessary duplication due to operating two separate companies in respect of corporate governance, auditing, compliance, management, etc. If the Scheme were not to proceed then it would be harder for the North Group to achieve the desired level of savings. I have been told that this would call into question the long-term strategic rationale for continuing to operate SMI.
- 9.26 The Brexit Part VII would not be affected were the Schemes not to proceed, other than the proposed transfer would then be of the non-UK EEA business to North EU from both NOE and SMI rather than just from NOE.

LEGAL JURISDICTION

- 9.27 I understand that (pre-Brexit) 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 sanctioned transfer subsequent to its effective date.
- 9.28 I have been told that approximately 48% of the outstanding claims provisions, gross of reinsurance (43% net of reinsurance) relating to the Transferring Business are in respect of non-EEA business, some of which might be in respect of policies governed by laws other than those of one of the EEA states. I note that roughly a half of the non-EEA outstanding claims provisions, gross of reinsurance, relates to US business. Therefore, there is a risk that such a challenge might be made.

- 9.29 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. As discussed in paragraph 5.31, above, I have seen a legal opinion, obtained by the North Group, which discussed the applicability of the assumption reinsurance arrangement pertaining to the US Surplus Lines business. The opinion also discussed what might happen should such a claim to be brought before a US court seeking to declare invalid a ruling by the Court on a Part VII transfer. The opinion provided was that 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 Schemes.
- 9.30 I have not seen similar advice regarding the likely response of courts in any other legal jurisdiction to similar actions being brought forward.

TAX

- 9.31 The North Group has engaged an external firm of tax advisors to advise on the tax implications of the Schemes on either of the Companies. I have been told that they do not anticipate any material tax issues or liabilities associated with the Schemes.

COSTS OF THE SCHEMES

- 9.32 The external costs of the Schemes (estimated to be about £750,000-£800,000) will be met by NOE. These costs are not such as to affect the solvency of NOE or the security of any group of policyholders.

10. CONCLUSIONS

10.1 In summary, in my opinion, provided the proposed Schemes operate as intended, and I have no grounds for believing that they will not do so:

- Neither the Scheme nor the Jersey Scheme will materially adversely affect the security of benefits to policyholders of either SMI (both those policyholders being transferred under the Scheme and those who are holders of Residual Policies) or NOE;
- Neither the Scheme nor the Jersey Scheme will have any impact on service standards (operated in accordance with TCF criteria) experienced by the policyholders of either SMI (both those policyholders being transferred under the Scheme and those who are holders of Residual Policies) or NOE;
- Neither the Scheme nor the Jersey Scheme will have any effect on the rights of existing members of NOE to secure or prevent further changes that could affect their entitlements as policyholders; and
- The effect of the Jersey Scheme is not to treat policyholders of business written by SMI under Jersey authorisation in a manner that is either more or less favourable than the treatment applied to equivalent policyholders of business written under authorisation other than that of Jersey.

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

- I have considered which parties might be affected by the Schemes 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 SMI and NOE. 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 Schemes has not been considered.
- I have considered how the Schemes 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 SMI and NOE having adopted alternative plausible assumptions
- I have not considered alternative arrangements.



Derek Newton / 18 February 2020

Fellow of the Institute and Faculty of Actuaries

Appendix A Definitions

TERM	DEFINITION
Accident year	The year in which an incident that gives rise to an insurance claim occurs.
AFR	Actuarial Function Report, a report prepared at least annually by the Actuarial Function for the Board of the relevant insurer.
AOF	Ancillary own funds, which are off-balance sheet funds that are available under Solvency II (subject to certain limits) to meet solvency capital requirements.
APH	Asbestos, pollution and health hazards.
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.
BBNI	Bound But Not Incepted.
Best estimate	This term is used in this Report in reference to an estimate of outstanding claim amounts and is intended to represent an expected value over a reasonable range of estimates. As such a “best estimate” is not deliberately biased upwards or downwards, and does not include any margins. However, the limitations of actuarial projection methods mean that a “best estimate” is not a statistically rigorous estimate of the mean of the underlying distribution of all possible outcomes.
B-F	The Bornhuetter-Ferguson method, which is a commonly used actuarial method for estimating claim reserves.
Brexit	“Brexit” refers to the exit of the UK from the European Union on 31 January 2020, following the referendum on continuing membership held in the UK in June 2016. As at the time of drafting this Report, the future relationship between the UK and the EU, including the regulatory environment for insurers operating across UK/EEA borders, was being negotiated. Until the completion of the transition period (currently scheduled to finish on 31 December 2020) the regulatory environment for insurers remains unaltered from its pre-Brexit state.
Brexit Part VII	The proposed Part VII Transfer of the Legacy EEA Business from NOE to North EU.
Can\$	Canadian Dollars.
Canada Assumption Reinsurance	The reinsurance by which a third party insurer will assume full liability for the outstanding liabilities relating to the hull and liability business of SMI’s Canada Branch.
Canada Effective Date	The date on and from which the Canada Assumption Reinsurance becomes effective.
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.
Chain Ladder	A commonly used actuarial method for estimating claim reserves.
The Companies	The collective term for SMI and NOE.
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.
CRO	Chief Risk Officer.

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.
EEA Passport Rights	The right under the EU directives (and as manifested in the Financial Services and Markets Act 2000 (EEA Passport Rights) Regulations 2001 (as amended)) for UK regulated insurers to operate freely in other EEA countries.
Effective Date	The date on and from which the Schemes shall become effective.
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.
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.
EU	European Union.
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.
FDD	Freight, Demurrage and Defence, a type of insurance cover.
FG18/4	Guidance published by the FCA in May 2018 relating to Part VII insurance business transfers.
Financial Year	Financial Year X for the entities that comprise the North Group is the 12 month period year running from noon on 20 February X to noon on 20 February X+1.
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.
GMT	Greenwich Mean Time.
HMU	Harlock Murray Underwriting Limited.
IBNR	Incurred but not reported.

IBNR reserves	These are reserves in respect of claims that relate to claim events that have occurred before the valuation date but which 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.
IDD	The Insurance Distribution Directive, which has applied in the UK (and in all other EU Member States) with effect from 1 October 2018.
IELR	Initial expected loss ratio.
IFoA	The Institute and Faculty of Actuaries, the professional body for actuaries in the UK.
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.
Independent Actuary	The Independent Actuary prepares the Jersey Report and provides it to the Jersey 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 Jersey Scheme, I have been appointed as the Independent Actuary.
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.
International Group	The International Group of P&I Clubs, an unincorporated association of thirteen principal protection and indemnity underwriting associations (the P&I Clubs) and their affiliated associations and reinsured entities.
Jersey Court	The Royal Court of Jersey.
Jersey Report	The report on the terms of the Jersey Scheme that must accompany any application to the Jersey Court for an order sanctioning an insurance business transfer scheme.
Jersey Scheme	The insurance business transfer scheme, pursuant to Article 27 and Schedule 2 of the Insurance Business (Jersey) Law 1996, by which SMI's Jersey Business will be transferred to NOE.
Knighthood	Knighthood Corporate Assurance Services plc, an insurance broker.
KPI	Key Performance Indicator.
Legacy EEA Business	Non-UK EEA business that that was written by either NOE or SMI and that incepted prior to 20 February 2019.
Mack Method	A statistical technique developed by a German statistician, Thomas Mack, to estimate ultimate claim amounts at different confidence levels.
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).
Milliman	Milliman LLP, a member of the Milliman Group.
The Milliman Group	The group of entities whose ultimate parent is Milliman, Inc.
MSM	Minimum Margin of Solvency, which is an absolute floor for the required solvency capital of Bermuda-regulated (re)insurers (but which varies between the different classes of (re)insurers).

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.
NEMIA	The North of England Mutual Insurance Association (Bermuda) Limited
NGSL	North Group Services Ltd., a group employee holding company within the North Group.
NOE	The North of England Protecting and Indemnity Association Limited
NOE DB Scheme	NOE's defined benefit pension scheme.
North Group	The group of companies comprising NOE and its direct and indirect subsidiaries (including SMI).
NRFC	Norton Rose Fulbright Canada LLP
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.
OSFI	The Office of the Superintendent of Financial Institutions (OSFI) is an independent agency of the Government of Canada, which supervises and regulates federally registered banks and insurers, trust and loan companies, as well as private pension plans subject to federal oversight.
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 AOFs (e.g. additional premiums from members), which require regulatory approval.
P&I	Protection and indemnity insurance for ship owners.
Parental Guarantee	A guarantee provided by NOE to SMI whereby NOE is ultimately responsible for the liabilities of SMI and guarantees payment of all of SMI's obligations to its policyholders so as to ensure that they are promptly and adequately discharged in circumstances where SMI does not or is unable to do so.
Part VII Transfer	An insurance business transfer scheme performed in accordance with the requirements set out in Part VII of FSMA.
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.
Policy Year	The year to which a claim is allocated based on the date the policy was written. Policy Year X runs from noon on 20 February X to noon on 20 February X+1.
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.
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.
Report	References to the "Report" refer to this report.

Report Summary	The summary of this Report, prepared specifically to be included in a document that also summarises the Schemes and which will be made available to policyholders of the Companies and to others who might be affected by the Schemes.
Residual Policy	A contract of insurance (if any) written or assumed by SMI 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.
RPPD	The Responsibilities of Providers and Distributors for the Fair Treatment of Customers, a guidance document published by the FCA in January 2018.
The Scheme	In the context of this Report, the proposal that the transferring business of SMI and of MIC be transferred to NOE under the provisions of Part VII of FSMA.
The Schemes	The collective term for the Scheme and the Jersey Scheme.
SCR	The Solvency Capital Requirement ("SCR") under Solvency II is the amount of capital required to ensure continued solvency over a one-year trading time frame with a likelihood of 99.5%.
SFCR	Each insurer is expected to publish a Solvency and 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 II	The system for establishing (among other things) minimum capital requirements for EU (re)insurers under the Solvency II Directive 2009/138/EC.
SMI	Sunderland Marine Insurance Company Limited.
SMI DB Scheme	SMI's defined benefit pension scheme.
SMI's Jersey Business	The business written by SMI in circumstances that required SMI to be authorised under Jersey law.
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.
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 I for further details).
TPs	Technical provisions as calculated for Solvency II purposes. As such they differ from technical provisions calculated on an IFRS basis.
Transfer Documents	The documents that sets out the terms of the Scheme and of the Jersey Scheme.
Transferee	The entity to which business is being transferred – in the case of the Scheme this is NOE.
Transferor	The entity from which business is being transferred – in the case of the Scheme this is SMI.
Transferring Business	The business of SMI that is to be transferred to NOE under the Scheme.
Transferring Assets	The assets of SMI that are to be transferred to NOE under the Scheme.

Transferring Policyholders	The policyholders of the Transferring Business.
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.
UPR	Unearned premium reserve.
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.
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.

Appendix B Reinsurance Arrangements for NOE and SMI

I have included below schema that illustrate the reinsurance arrangements for NOE and for SMI in respect of the 2019 policy year, excluding the 90% quota share provided by NEMIA. The reinsurance programmes for other years differ from this, although there are similarities in the overall structures.

FIGURE B.1 2019 IG GXL STRUCTURE

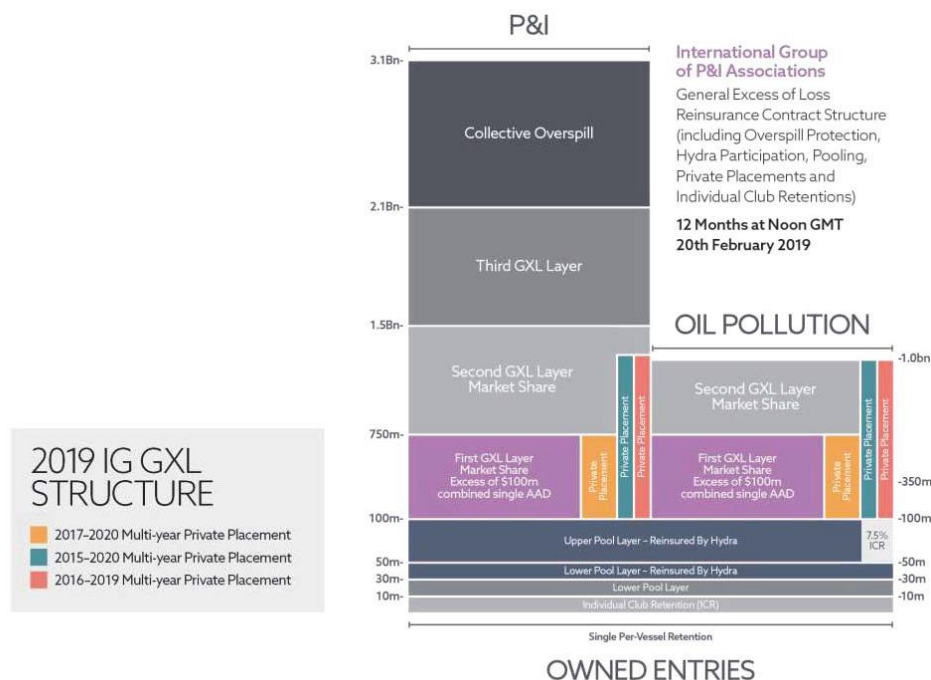


FIGURE B.2 2019 RETENTION REINSURANCE STRUCTURE (INCLUDING MARINE LIABILITY FOR SMI)

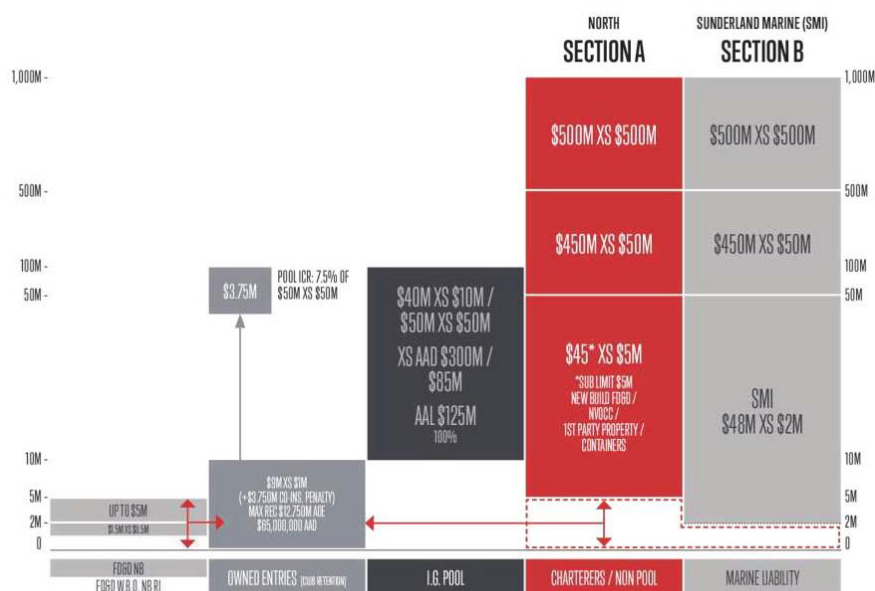
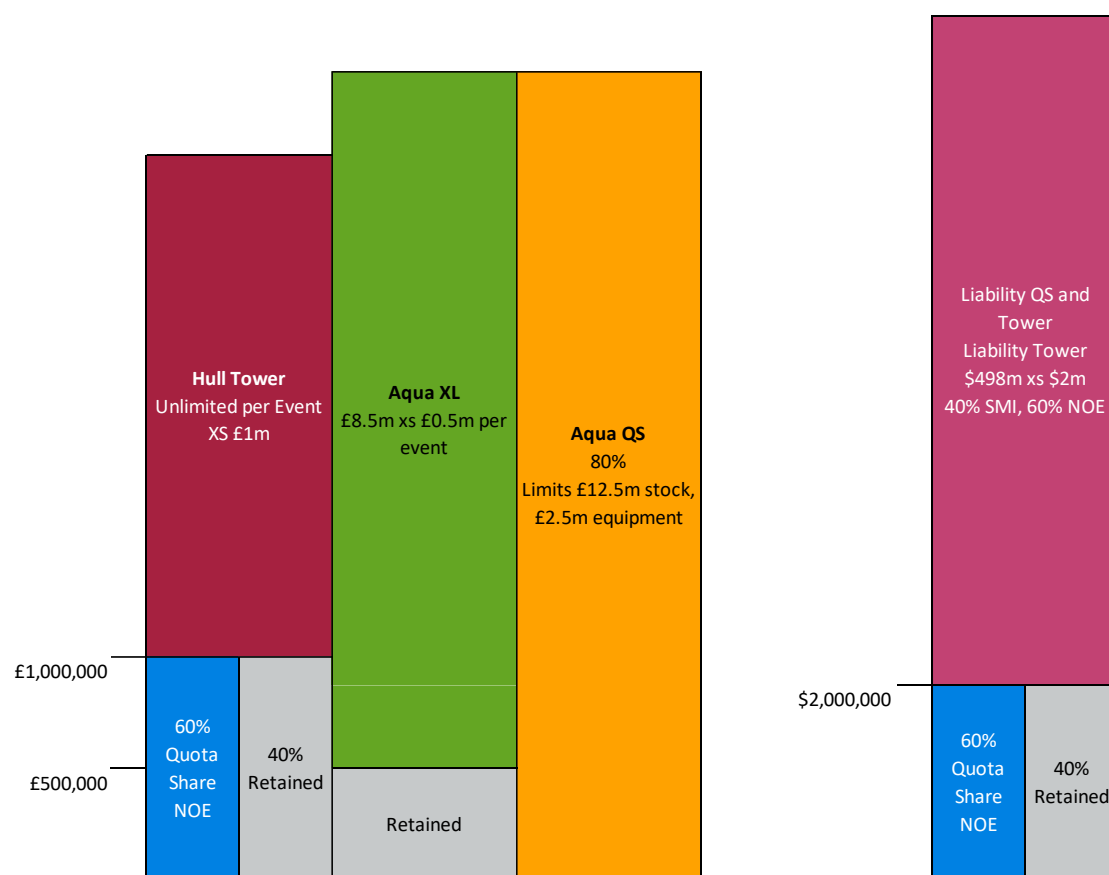


FIGURE B.3 2019 SMI PROGRAMME



Appendix C CV for Derek Newton

- C.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.
- C.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:
 - C.2.3 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.
 - C.2.4 Assisting insurers with the preparation of solvency capital assessments, both internal and in accordance with prevailing regulatory requirements.
 - C.2.5 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.
 - C.2.6 Providing independent expert support to insurers arranging transfers of business between themselves (see below).
 - C.2.7 Providing Actuarial Function support to several insurers.
 - C.2.8 Leading the evaluation of the reinsurance strategy and reinsurance programme for a major insurer.
 - C.2.9 Leading the review of various European insurers as part of due diligence assignments
- C.3 Of particular relevance in this context, Derek acted as the independent expert in respect of the following Part VII transfers:
 - C.3.10 The transfer of the general insurance business of RL(CIS) Limited to CIS General Insurance Limited, a transfer that was sanctioned in 2014;
 - C.3.11 The transfer of general insurance business relating to the Tower pool from Royal & Sun Alliance Insurance PLC to Knapton Insurance Limited, a transfer that was sanctioned in 2015;
 - C.3.12 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;
 - C.3.13 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;
 - C.3.14 The transfer of general insurance business from Royal & Sun Alliance Insurance PLC and from The Marine Insurance Company Limited to Mercantile Indemnity Company Limited, a transfer that was sanctioned in 2019.
- C.4 In addition, Derek has been peer reviewer to the Independent Expert in the following transfers.
 - C.4.15 the general insurance business of various UK-regulated subsidiaries of the Royal Sun Alliance Insurance Group to a smaller number of UK-regulated subsidiaries of Royal Sun Alliance Insurance Group. The transfers were approved by the Court on 12 December 2011;
 - C.4.16 the general insurance business of PA(GI) Limited to Royal Sun Alliance Insurance and to Marine Insurance Company Limited. The transfers were approved by the Court on 12 December 2011;

- C.4.17 certain general insurance business of the Italian branch of Sampo Japan Insurance Company of Europe Limited to Berkshire Hathaway International Insurance Limited. The transfer was effective 31 March 2013;
 - C.4.18 the general insurance business of Chevanstell Limited to R&Q Insurance (Malta) Limited. The transfer was effective 31 December 2013;
 - C.4.19 the European branch general insurance business of Mitsui Sumitomo Insurance Company (Europe) Limited to MSIG Insurance Europe AG. The transfer was effective 31 December 2013;
 - C.4.20 the EEA general insurance businesses of Sampo Japan Nipponkoa Insurance Company of Europe Limited and Endurance Worldwide Insurance Limited to SI Insurance (Europe), SA and the non-EEA business of Sampo Japan Nipponkoa Insurance Company of Europe Limited to Endurance Worldwide Insurance Limited. The transfer was effective 31 December 2018;
 - C.4.21 the business of the Irish, Dutch, French and German branches of Travelers Insurance Company Limited to Travelers Insurance DAC. The transfer was effective 1 October 2019.
- C.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.
- C.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 D Scope of the Work of the Independent Expert in relation to the Scheme and of the Independent Actuary in relation to the Jersey Scheme

The following was included within the letter of engagement that was agreed between the Companies, Milliman and me, and which 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 is to 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 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 relative solvency margins of the Companies;*
- The future business plans and the capital management policy to be adopted by North following implementation of 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.*

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 transfer 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 report (and drafts of it) and any supplemental report with those noted at Clause 4(b) of the engagement letter.

I will produce (i) the Part VII Report for submission to the Court; (ii) a supplementary report to the Part VII Report for submission to the Court at the final court hearing; and (iii) a summary of the Part VII Report that forms part of the Scheme summary for inclusion within letters to policyholders (or approve such a summary if prepared by the Companies). I will share the Part VII Report (and drafts) and any supplemental report with those noted at paragraph 6(b) of the engagement letter.

If required, I will attend the Court hearings.

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

In fulfilling my role as Independent Actuary for the Jersey Scheme, I will apply the same considerations to the Jersey business and policyholders of the Companies as I have to the overall business and policyholders of the Companies in my role as Independent Expert for the Scheme.”

Appendix E General Considerations of the Independent Expert in relation to the Scheme and of the Independent Actuary in relation to the Jersey Scheme

INTRODUCTION

- E.1 I have compiled my Report in accordance with the Policy Statement and with SUP18.
- E.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.
- E.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

- E.4 After considering the effects of the Scheme on each of the different groups of policyholders affected by the Scheme (as identified in paragraph 5.33, 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.
- E.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.
- E.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

- E.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.
- E.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.

E.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.

E.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).

EFFECT ON MEMBERS

E.11 SUP 18.2.38 requires that I describe the effect of the Scheme on the proprietary rights of the members of NOE, including the significance of any loss or dilution of the rights of those members to secure or prevent further changes that could affect their entitlements as policyholders. I should also consider and comment on the appropriateness of any compensation paid under the Scheme to members for any diminution of proprietary rights.

TREATING CUSTOMERS FAIRLY

E.12 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.

E.13 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

E.14 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.

E.15 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.

E.16 Any requirements for P&I clubs and especially for those transferring from an insurance company and having a different ranking from P&I club policyholders.

THE INDEPENDENT ACTUARY

E.17 In fulfilling my role as Independent Actuary for the Jersey Scheme, I have applied the same considerations to the Jersey business and policyholders of SMI and NOE as I have to the overall business and policyholders of SMI and NOE in my role as Independent Expert for the Scheme.

Appendix F Compliance with the PRA Policy Statement

The table below indicates how I have complied with the provisions of the PRA Policy Statement (*"The Prudential Regulation Authority's approach to insurance business transfers"*, dated April 2015) that pertain to the form of the Report. I have not included references to paragraphs in the Executive Summary of this Report; there should be nothing in the Executive Summary that has not been stated or explained in other parts of the Report.

I note that, in preparing this Report, I have also been mindful of the contents of SUP18 and FG18/4.

PRA Policy Statement Reference	Requirement	Scheme Report paragraph reference
2.30 (1)	Who appointed the Independent Expert and who is bearing the costs of that appointment	1.4, 1.18, 1.24, 5.8, 5.64, 9.32
2.30 (2)	Confirmation that the independent expert has been approved or nominated by the appropriate regulator	1.4, 1.18
2.30 (3)	A statement of the independent expert's professional qualifications and (where appropriate) descriptions of the experience that fits him for the role	1.19, Appendix C
2.30 (4)	Whether the independent expert, or his employer, has, or has had, direct or indirect interest in any of the parties that might be thought to influence his independence, and details of any such interest	1.20-1.22
2.30 (5)	The scope of the report	1.25-1.41
2.30 (6)	The purpose of the Scheme(s)	5.10-5.11
2.30 (7)	A summary of the terms of the scheme in so far as they are relevant to the report	5.1-5.9
2.30 (8)	What documents, reports and other material information the independent expert has considered in preparing his report and whether any information that he requested has not been provided	Appendix G
2.30 (9)	The extent to which the independent expert has relied on: (a) information provided by others; and (b) the judgment of others	1.44, 5.20, 5.31, 9.29, □
2.30 (10)	The people on whom the independent expert has relied and why, in his opinion, such reliance is reasonable	5.24, 5.31, 9.29
2.30 (11)	His opinion of the likely effects of the scheme on policyholders (this term is defined to include persons with certain rights and contingent rights under the policies), distinguishing between: (a) transferring policyholders; (b) policyholders of the transferor whose contracts will not be transferred; and (c) policyholders of the transferee	Section 6 Section 7 Section 8
2.30 (12)	His opinion on the likely effects of the scheme on any reinsurer of a transferor, any of whose contracts of reinsurance are to be transferred by the scheme	9.9-9.14
2.30 (13)	What matters (if any) that the independent expert has not taken into account or evaluated in the report that might, in his opinion, be relevant to policyholders' consideration of the scheme	None of which I am aware, other than 9.22

2.30 (14)	For each opinion that the independent expert expresses in the report, an outline of his reasons	6.25, 6.41, 6.86, 6.103, 6.120, 6.135, 6.141, 6.145, 6.147, 6.151, 6.158, 6.159, 7.9, 8.4, 8.9, 8.11, 8.14, 8.16, 8.18, 8.19, 9.14 Section 10
2.32 (1)	The summary of the terms of the scheme should include a description of any reinsurance agreements that it is proposed should pass to the transferee under the scheme	5.1-5.9
2.32 (2)	The summary of the terms of the scheme should include a description of any guarantees or additional reinsurance that will cover the transferred business or the business of the transferor that will not be transferred	5.35
2.33 (1)	The independent expert's opinion of the likely effects of the scheme on policyholders should include a comparison of the likely effects if it is or is not implemented	9.23-9.25
2.33 (2)	The independent expert's opinion of the likely effects of the scheme on policyholders should state whether he considered alternative arrangements and, if so, what	1.26
2.33 (3)	The independent expert's opinion of the likely effects of the scheme on policyholders should, where different groups of policyholders are likely to be affected differently by the scheme, include comment on those differences he considers may be material to the policyholders	5.33, Section 6, Section 7, Section 8
2.33 (4)	<p>The independent expert's opinion of the likely effects of the scheme on policyholders should include his views on:</p> <p>(a) the effect of the scheme on the security of policyholders' contractual rights, including the likelihood and potential effects of the insolvency of the insurer;</p> <p>(b) the likely effects of the scheme on matters such as investment management, new business strategy, administration, expense levels and valuation bases in so far as they may affect:</p> <p>(i) the security of policyholders' contractual rights;</p> <p>(ii) levels of service provided to policyholders; or</p> <p>(iii) for long-term insurance business, the reasonable expectations of policyholders; and</p> <p>(c) the cost and tax effects of the scheme, in so far as they may affect the security of policyholders' contractual rights, or for long-term insurance business, their reasonable expectations</p>	<p>6.135, 6.151, 6.159, 7.9, 8.19</p> <p>6.141, 7.5, 8.9</p> <p>6.142-6.147</p> <p>9.31, 9.32</p>
2.35 (1)	For any mutual company involved in the scheme, the report should describe the effect of the scheme on the proprietary rights of members of the company, including the significance of any loss or dilution of the rights of those members to secure or prevent further changes that could affect their entitlements as policyholders	8.12-8.14
2.35 (2)	For any mutual company involved in the scheme, the report should state whether, and to what extent, members will receive compensation under the scheme for any diminution of proprietary rights	Not applicable, as there would be no diminution

2.35 (3)	For any mutual company involved in the scheme, the report should comment on the appropriateness of any compensation, paying particular attention to any differences in treatment between members with voting rights and those without	Not applicable, as there would be no diminution
2.36 (1)	For a scheme involving long-term insurance business, the report should describe the effect of the scheme on the nature and value of any rights of policyholders to participate in profits	Not applicable
2.36 (2)	For a scheme involving long-term insurance business, the report should, if any such rights will be diluted by the scheme, how any compensation offered to policyholders as a group (such as the injection of funds, allocation of shares, or cash payments) compares with the value of that dilution, and whether the extent and method of its proposed division is equitable as between different classes and generations of policyholders	Not applicable
2.36 (3)	For a scheme involving long-term insurance business, the report should describe the likely effect of the scheme on the approach used to determine: (a) the amounts of any non-guaranteed benefits such as bonuses and surrender values; and (b) the levels of any discretionary charges	Not applicable
2.36 (4)	For a scheme involving long-term insurance business, the report should describe what safeguards are provided by the scheme against a subsequent change of approach to these matters that could act to the detriment of existing policyholders of either firm	Not applicable
2.36 (5)	For a scheme involving long-term insurance business, the report should include the independent expert's overall assessment of the likely effects of the scheme on the reasonable expectations of long-term insurance business policyholders	Not applicable
2.36 (6)	For a scheme involving long-term insurance business, the report should state whether the independent expert is satisfied that for each firm the scheme is equitable to all classes and generations of its policyholders	Not applicable
2.36 (7)	For a scheme involving long-term insurance business, the report should state whether, in the independent expert's opinion, for each relevant firm the scheme has sufficient safeguards (such as principles of financial management or certification by a with-profits actuary or actuarial function holder) to ensure that the scheme operates as presented	Not applicable

Appendix G Key Sources of Data

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

Background

- SMI Directors' Report, Strategic Report and Financial Statements as at 20 February 2019
- NOE Directors' Report as at 20 February 2019
- NEMIA Financial Statements 2019
- North Group Directors' Report for the Period Ended 31 December 2019
- Combined financial statements for the North Group as at 20 February 2019
- Written notice from the PRA varying the permission of NOE under Part 4A of the FSMA
- P&I Rules 2019-20
- Deed of resolution, dated 15 November 2018, amending the Articles of Association for NOE
- Spreadsheet showing the composition of NOE business written for the policy year 2017-19, expressed as premiums both gross and net of reinsurance, by flag and place of management
- Spreadsheet showing the composition of NOE reserves as at 20 February 2019, by place of management
- An undated report on strategy, presented to the NOE Board in September 2018
- Five Year Business plan for the North Group, covering the period February 2019 - February 2024, supported by a multisheet Excel file, showing the projected profit & loss accounts and balance sheets for the entities within the North Group
- Board paper, proposing changes to the North Group's vision statement, key strategic goals and key performance indicators

Scheme and Restructuring

Global

- Slide Deck for NOE meeting with PRA July 2017
- Slide Deck for NOE update meeting with PRA and FCA November 2017
- Slide Deck for NOE update meeting with PRA and FCA July 2019
- Draft Scheme Document (dated 9 October 2019)

Canada

- Legal opinion from Norton Rose Fulbright Canada LLP regarding the Canada Assumption Reinsurance, dated 4 December 2017
- List of claims outstanding as at 19 August 2019

US

- Indemnity Assurance Agreement dated 20 December 2017 between the US Branch of SMI and NOE
- Assumption and Assignment Agreement, dated 5 October 2018, between NOE and SMI whereby NOE assumes SMI's liabilities in respect of its liabilities in respect of its US Trust Funds
- Voluntary Surrender of Certificate of Authority in respect of SMI's operations in Alaska, dated 20 December 2017 (countersigned by the Chief Financial Examiner and a Director of the Alaska Division of Insurance)
- Legal opinion from Locke and Lord LLP regarding the legal process for transferring US policies and claims liabilities, dated 4 December 2017

Australasia

- Authorisation (and covering letter), dated 24 August 2018, from the Australian Prudential Regulation Authority ("APRA") for NOE to carry on insurance business in Australia
- Australian Financial Services Licence (and covering letter) authorising NOE to carry on financial services business in Australia with effect from 16 November 2018

- Order, dated 2 November 2018, from the Federal Court of Australia for the business of SMI's Australian branch to be transferred to SMI
- Copy of the transfer agreement, dated 5 September 2018, between SMI and NOE, whereby the business of SMI's Australian branch would be transferred to SMI, the Effective Date of which was 2 November 2018
- Copy of the transfer agreement, dated 1 November 2018, between SMI and NOE, whereby the business of SMI's New Zealand branch would be transferred to SMI
- Letter dated 9 October 2018, from the Reserve Bank of New Zealand ("the Reserve Bank") to NOE, enclosing the licence to operate in New Zealand issued to NOE by the Reserve Bank, and approving the transfer to NOE of the business of SMI's New Zealand branch

Reserving

- NOE Claims Reserving Policy, dated 5 January 2018
- SMI Claims Reserving Policy, dated 5 January 2018
- Spreadsheet file showing SMI outstanding claims relating to Jersey and to Alaska
- Spreadsheet file, dated May 2019, showing the layers and limits that the North Group is exposed to through its membership of the International Group
- NOE Reserving Report as at 20 February 2018, including the exhibits
- NOE Reserving Report as at 20 February 2019, including the exhibits
- SMI Reserving Report as at 20 February 2018, including the exhibits
- SMI Reserving Report as at 20 February 2019, including the exhibits
- Various spreadsheet files, showing the reconciliation between the reserving reports and the technical provisions booked in the financial statements for NOE and SMI as at 20 February 2019
- Agenda papers for the meeting of NOE's Reserving Committee on 18 March 2019
- Extract from the report of the North Group's auditors on the accounts as at 20 February 2019, focusing on the technical provisions
- Spreadsheet file of claims and premium data as at 30 August 2019 relating to SMI Jersey business written in 2018 and 2019
- A paper from a third party actuarial firm to the North Group's Audit Committee, entitled *Actuarial Function Report (component) – Review of Solvency II technical provisions as at 20 February 2019* and dated 9 August 2019

Risks and Solvency Capital

- NOE ORSA as at December 2018 and as at December 2019
- SMI ORSA as at December 2018 and as at December 2019
- NOE and North Group Stress Testing Report as at December 2019
- SMI Stress Testing Report as at December 2019
- Risk Management Framework for the North Group, as at November 2018
- Technical Support Document for the North Group in respect of the Remetrica capital model and the business planning processes (created 8 May 2017, updated 12 February 2018)
- 2017 SFCR for the North Group as at 20 February 2019
- 2017 SFCR for NOE as at 20 February 2019 (on a solo basis)
- 2017 SFCR for SMI as at 20 February 2019
- QRTs for NOE as at 20 August 2019 (on a solo basis)
- QRTs for SMI as at 20 August 2019
- A spreadsheet that showed the movement in the Eligible Own Funds and the SCR for NOE between 20 February 2019 and 20 August 2019
- Written Notice to NOE from the PRA, dated 16 February 2017, approving the use of AOFs according to a formula set out in the written notice

- A paper from Willis Towers Watson to NOE and SMI, entitled Pension Obligation Risk Capital Review and dated 2 August 2018

Reinsurance and Guarantees

- NOE Board reports on outwards reinsurance (excluding intragroup cover): I have been provided with versions of this paper as presented to the NOE Board in January 2018 and 2019, May 2018 and 2019, and November 2018
- NOE Board Report on outwards reinsurance provided by NEMIA, as presented to the NOE Board in September 2018
- SMI Board Report on outwards reinsurance (excluding intragroup cover): I have been provided with versions of this paper as presented to the SMI Board in January 2018, September 2018 and January 2019
- Debenture agreement between NEMIA and NOE, dated 17 December 2018
- Contract whereby NOE provides quota share reinsurance to SMI, incepting 1 January 2019, and covering risks incepting during the policy year 2019
- Parental Guarantee contract dated 28 February 2014
- Deed of Priority, dated 17 December 2018

Governance

- North Group Corporate Governance Manual, dated 14 August 2019
- The KPI Dashboard
- Group Investment Committee terms of reference
- Group Management Responsibilities Map for the North Group

Conduct Risk

- Supply Agreement, between NGSL, NOE, SMI and North EU, dated 17 December 2018
- Secondment Agreement, between NGSL and NOE (in respect of NOE's branches in Australia and New Zealand), dated 28 February 2019
- TCF Policy for SMI (last updated August 2019)
- Complaints Policy and Procedures for the North Group (updated August 2019)
- Three sample complaints forms for the North Group

Other

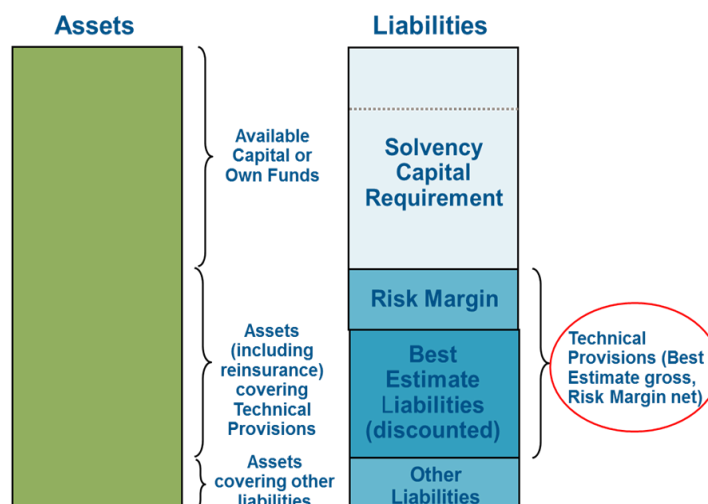
- Deed of Amendment and Flexible Apportionment Arrangement relating to the SMI Pension Scheme, dated 1 February 2018
- Draft Witness Statement (dated 14 October 2019) by Paul Jennings, Chief Executive Officer of both NOE and SMI (no exhibits attached).

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

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

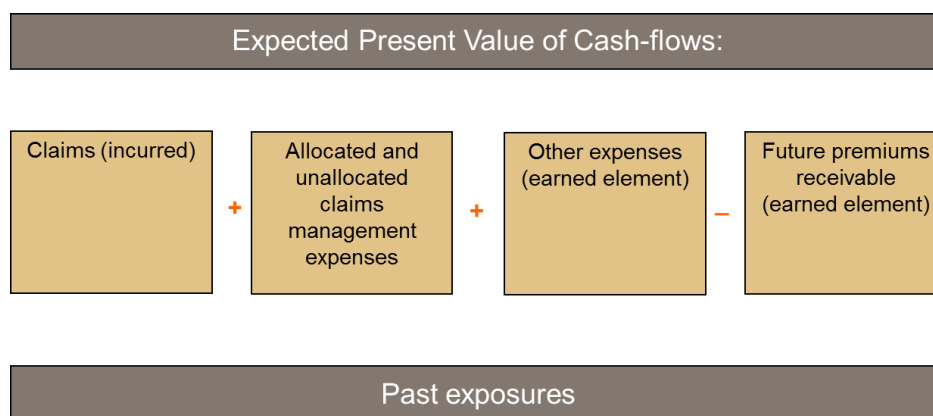


- H.2 The Solvency II balance sheet is intended to be a tool for management to assess an entity's solvency and hence an important consideration for significant decisions. It is also a tool for regulators to assess the solvency of an insurer.
- H.3 A key consideration for management in making significant decisions will be the excess of assets over TPs, 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 TPs 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 TPs (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 TPs 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 TPs are made up as follows:

Claims provision + Premium provision + Risk margin

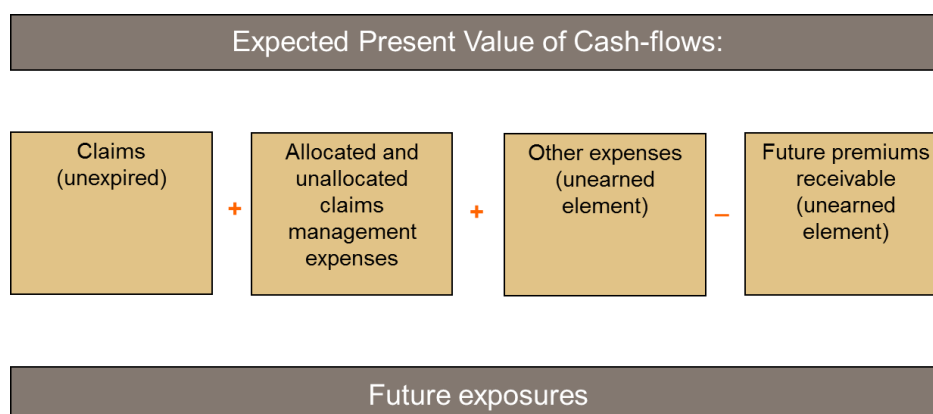
- H.6 The claims provision is the expected present value/discouted 'best estimate' of all future cash-flows (claim payments, expenses and future premiums due) relating to claim events prior to the valuation date. H.2, below, illustrates the components of the claims provision calculation.

FIGURE H.2 CLAIM PROVISION



- H.7 The premium provision is the expected present value/discouted '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 hedgeable); and
- r_t is the risk-free discount rate(s) at time t, as provided by EIOPA for all major currencies.

Appendix I Key Differences Between IFRS and Solvency II Technical Provisions

I.1 A summary of the key differences between IFRS reserves and Solvency II TPs is set out in the table below:

Area of change	UK GAAP Reserves	Solvency II Technical Provisions	Balance sheet impact
Earned business	Claims reserve = point estimate within a reasonable range ("not insufficient")	Claims provision = probability weighted average of future cash flows	Reduces liabilities (removes margins)
Unearned business	Unearned premium reserve, net of Deferred Acquisition Costs	Premium provision = probability weighted average of future cash flows	Reduces liability (expected profit)
Risk Margin	n/a	Explicit item, based on cost of capital approach	Increases liabilities
Discounting	Undiscounted	Discounted cash flows	Reduces liabilities
Contract recognition	Policies written	Policies written and legally bound Unincepted policies ("BBNI" policies')	Reduces liabilities (due to expected profit on BBNI policies)
Expenses	Claims handling expense reserve	More explicit treatment of expenses	Increases liabilities
Events Not In Data ("ENIDs")	Limited allowance for contingent liabilities	New concept allowance for extreme outcomes (which are "not in the data" used for reserving)	Increase liabilities
Reinsurance Bad Debt Provision	n/a	Explicit provision required for reinsurer bad debt	Increases liabilities