Report of the Independent Expert on the proposed transfer of two RSA Italian branches from Royal & Sun Alliance Insurance plc and Sun Insurance Office Limited respectively, to ITAS Mutua

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1. PURPOSE AND SCOPE

Purpose of the Report

1.1 It is proposed that the Italian branch business of Royal & Sun Alliance Insurance plc ("RSAI") and the Italian branch business of Sun Insurance Office Limited ("SIO") be transferred to Istituto Trentino-Alto Adige per Assicurazioni Societa Mutua di Assicurazioni ("ITAS") by an insurance business transfer scheme (the "Scheme") as defined in Section 105 of the Financial Services and Markets Act 2000 ("FSMA").

1.2 Section 109 of FSMA requires that an application to the High Court of Justice in England and Wales (the "Court") for an order sanctioning an insurance business transfer scheme must be accompanied by a report on the terms of the transfer (the "Report") by an independent person (the "Independent Expert") having the skills necessary to make the report and who is nominated or approved by the Prudential Regulation Authority ("PRA"), having consulted with the Financial Conduct Authority ("FCA"). The Report is required in order that the Court may properly assess the impact of the proposed transfer, including the effect on the policyholders of the insurance companies in question.

1.3 RSAI, SIO and ITAS have nominated me to act as Independent Expert to provide the Report in respect of the Scheme, and the PRA has approved my appointment (see paragraph 1.11 below).

1.4 This Report describes the proposed transfers and discusses their possible effects on the policyholders of SIO, RSAI and ITAS (in respect of all business of SIO, RSAI and ITAS), including effects on security and levels of service. As such, the Report fulfils the requirements of the FSMA Report.

1.5 A list of terms defined in the Report is shown in Appendix A. Otherwise I use the same defined terms as are in the Scheme. Unless otherwise specified, references in the Report to the insurance business/policyholders of SIO, RSAI and ITAS are in respect of all general insurance and reinsurance business/policyholders of SIO, RSAI and ITAS.

The Proposed Scheme

1.6 In October 2014, RSAI, SIO and ITAS entered into a Business Sale and Transfer Agreement ("BSTA") relating to the sale of the Italian businesses of RSAI and SIO to ITAS. Under the terms of the BSTA, the parties agreed that they would seek the Italian businesses of RSAI and SIO to be transferred to ITAS by means of an insurance business transfer (as outlined in paragraph 1.1 above).

1.7 The business to be transferred under the Scheme (the "Transferring Business") is the entire business of the Italian branch of RSAI and the entire business of Italian branch of SIO. The Transferring Business comprises a mixture of domestic and multinational insurance business for Motor, Property & Engineering, Liability, Accident & Health, Bond and Marine classes.

1.8 The administration (including claims handling) of the Transferring Business is currently handled through a self-standing operation in Italy with local IT, risk, compliance and claims handling.

1.9 The Effective Date of the Scheme is expected to be 31 December 2015. The Scheme is intended to have the effect that all the liabilities under the policies comprising the Transferring Business will pass under the Scheme to ITAS.

1.10 The business involved in the Scheme, the arrangements for the Scheme and the effect of the Scheme are discussed in more detail in Sections 3 to 10 of the Report.

The Independent Expert

1.11 I, Gary Wells, have been appointed by RSAI, SIO and ITAS as the Independent Expert to consider the Scheme under Section 109 of FSMA. My appointment has been approved by the PRA; this was confirmed in a letter dated 26 January 2015.

1.12 I am a Principal of Milliman LLP ("Milliman") and I am based in its UK General Insurance practice in London. I am a Fellow of the Institute and Faculty of Actuaries which was established in 2010 by the merger of the Institute of Actuaries and the Faculty of Actuaries. I became a Fellow of the Institute of Actuaries in 1984. My experience of general insurance includes the (reserved) roles as the Signing Actuary to Lloyd's syndicates and Irish non-life insurance companies, as well as acting as the Independent Expert in a number of insurance business transfer schemes. A list of previous schemes for which I have acted as independent expert under the terms of FSMA, and as an independent actuary under the Insurance Companies Act 1982, the legislation replaced by FSMA, can be found in Appendix B.

1.13 I do not have, and have never had, any policies issued by any part of RSA Insurance Group plc ("RSAIG"), of which SIO and RSAI are both subsidiaries, or ITAS (the lead company in the ITAS Group). I am not a shareholder of RSAIG or a member of ITAS. I have undertaken no work for ITAS or, save as noted below, for RSAIG. I note that Milliman is part of Milliman, Inc., a global consulting firm and, as such, Milliman Inc. practices have worked with parts of RSAIG and ITAS on assignments globally. The main assignments carried out for RSAIG worldwide over the last five years were:

- I acted as the Independent Expert for a programme of Part VII transfers run by RSAIG as part of its preparations for Solvency II, which concerned the transfers of the business of various UK regulated subsidiaries of RSAIG to a smaller number of UK-regulated subsidiaries of RSAIG (as well as the transfer of business from PA(GI) Limited to RSAI and to Marine Insurance Company Limited – a subsidiary of RSAIG). The transfers were approved by the Court on 12 December 2011.
- Derek Newton, a Principal of Milliman, is presently acting as the Independent Expert for the proposed transfer of the Tower Pool business from RSAI to Knapton Insurance Limited. I have no involvement in this transfer.
- Neil Cantle, another Principal of Milliman, was seconded to RSA during 2011 to act as the Interim Head of Group Financial Risk. Other members of Milliman staff assisted him in that role from time-to-time.
- Milliman provides annual claim reserving and pension advice to the Global Aviation Pool of which the British Aviation Insurance Company Limited ("BAIC") has some shares though none since 2001. BAIC is 57% owned by RSAI.

1.14 A Milliman practice based in Italy carried out an assignment on behalf of ITAS in 2009. The fee income amounted to less than 0.1% of Milliman's global fee income for 2009. Otherwise, Milliman has not carried out any work for ITAS in the last 5 years.

1.15 The overall fee income that Milliman Inc. has received from RSAIG and ITAS Mutua worldwide in any of the last 5 years (2010 to 2014) has not exceeded 0.4% of Milliman, Inc.'s corresponding annual global revenue.

1.16 I do not believe that the involvement of other consultants within Milliman, Inc. with RSAIG, ITAS or their subsidiaries affects my ability to act independently in my assessment of the Scheme.

1.17 The Scheme is subject to sanction by the Court under Section 111 of FSMA.

1.18 I understand that RSAI, SIO and ITAS will share the costs of my work as Independent Expert, although RSAI will be responsible for payment of those fees.

The Scope of my Report

1.19 My terms of reference have been reviewed by the PRA and an extract is set out in Appendix C.

1.20 I have considered the terms of the Scheme only and have not considered whether any other scheme might provide a more efficient or effective outcome.

1.21 The Report describes the Scheme and the likely effects on policyholders of SIO, RSAI and ITAS, including effects on security and levels of service.

1.22 The Report should be read in conjunction with the full terms of the Scheme.

1.23 My work has required an assessment of the liabilities of SIO, RSAI and ITAS for the purposes of describing the effect of the Scheme. My review of the liabilities was based on the actuarial reserve assessments conducted by the respective internal actuaries of RSAI (and SIO) and ITAS (and on occasion external actuaries). 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 internal and external actuaries of SIO, RSAI and ITAS or to produce independent estimates of the liabilities.

1.24 In addition to the liabilities, I have assessed the appropriateness in nature and amount of any assets to be transferred under the Scheme (including the outwards reinsurance contracts), and the capital position of RSAI, SIO and ITAS pre and post Scheme. Again, I have not attempted to review in detail the calculations of the capital position performed by SIO, RSAI or ITAS or to produce independently my own estimates.

1.25 As far as I am aware, there are no matters which I have not taken into account in undertaking my assessment of the Scheme and in preparing the Report, but which nonetheless should be drawn to the attention of policyholders in their consideration of the Scheme.

1.26 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 SIO, RSAI and/or ITAS. I confirm that I have complied with this duty.

1.27 I am aware of the requirements regarding experts set out in Part 35 of the Civil Procedure Rules, Practice Direction 35 and the Protocol for Instruction of Experts to give Evidence in Civil Claims.

1.28 I confirm that I have made clear which facts and matters referred to in the 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.

1.29 The use of 'I' and 'my' in this Report generally refers to work done by myself and the team operating under my direct supervision during the course of this review (including relevant colleagues based in the Milan office of Milliman who have provided me with information about the Italian insurance market and the regulation thereof where such information was beyond my own knowledge and have provided me with English translations of relevant information provided by ITAS and RSAIG where such information was provided in Italian). Notwithstanding the above, when I use 'I' and 'my' in reference to an opinion, it is mine and mine alone.

1.30 Shortly before the date of the Court hearing at which an order sanctioning the Scheme will be sought, I will prepare a supplementary report (the "Supplementary Report") covering any relevant matters which might have arisen since the date of the Report. It is intended that the Supplementary Report will be published on the websites dedicated to the Scheme at least one week before the date of the final Court hearing.

The Structure of my Report

1.31 The remainder of the Report is set out as follows:

- In Section 2, I provide some background to the regulatory environment in which the companies involved in the Scheme operate;
- In Sections 3 and 4, I provide some background to SIO and RSAI, and ITAS, i.e. the companies involved in the Scheme;
- Section 5 summarises the key provisions of the Scheme;
- Section 6 describes the matters I need to consider as Independent Expert;
- In Section 7, I consider the likely impact of the Scheme on the transferring policyholders;
- In Section 8, I consider the likely impact of the Scheme on the policyholders of RSAI who would remain within RSAI after the transfer has taken place;
- In Section 9, I consider the likely impact of the Scheme on the current policyholders of ITAS;

- In Section 10, I cover more general issues relating to the Scheme and the management of SIO, RSAI and ITAS;
- My conclusions are summarised in Section 11.

Reliances and Limitations

1.32 In carrying out my review and producing the 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 RSAI, SIO and ITAS. Reliance has been placed upon, but not limited to, the information detailed in Appendix D. My opinions depend on the substantial accuracy of this data, information and the underlying calculations. I am unaware of, and have no reason to believe that there may be, 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.

1.33 The Report has been prepared for the purposes of the Scheme in accordance with Section 109 of FSMA. A copy of the Report will be sent to the FCA and PRA, and will accompany the Scheme application to the Court.

1.34 The Report must be considered in its entirety as individual sections, if considered in isolation, it may be misconstrued.

1.35 Neither the Report, nor any extract from it, may be published without me having provided my specific written consent, save that copies of the Report may be made available for inspection by policyholders, and copies may be provided to any person requesting the same in accordance with legal requirements. I also consent to the Report being made available on the websites dedicated to the Scheme.

1.36 No summary of the Report may be made without my express consent. I will provide a summary of the Report for inclusion in a document that will be made available to policyholders of RSAI, SIO and ITAS under the Scheme (the "Summary").

1.37 The Report has been prepared within the context of the assessment of the terms of the Scheme, and must not be relied upon for any other purpose. No liability will be accepted by Milliman, or me, for any application of the Report to a purpose for which it was not intended or for the results of any misunderstanding by any user of any aspect of the Report. In particular, no liability will be accepted by Milliman or me under the terms of the Contracts (Rights of Third Parties) Act 1999.

1.38 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 the Report. No warranty is given by Milliman or me that the assumptions, results and conclusions on which the Report is based will be reflected in actual future experience.

1.39 This review does not comprise an audit of the financial resources and liabilities of RSAI, SIO or ITAS.

1.40 The Report should not be construed as investment advice.

1.41 Nothing in the Report should be regarded as providing a legal opinion on the effectiveness of the Scheme.

1.42 In considering the background to RSAI, SIO and ITAS, the companies involved in the Scheme, and in considering the likely impact of the Scheme, I have made extensive use of financial information as at 31 December 2014 as that is the most recent date at which audited financial information is available. I have also taken into account updated financial information which has been made available to me, although I note that this updated information has not been audited. At the date of the Report, I am not aware of any material changes in circumstances since 31 December 2014 other than those referred to in the 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.

1.43 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.

1.44 The Report should not be used or relied upon for any purpose other than as the expression of my opinion on the impact of the Scheme in accordance with Section 109 of FSMA. I hereby expressly disclaim any liability to any party who relies or purports to rely on the Report for any other purpose whatsoever.

Professional and Regulatory Guidance

1.45 I am required to comply with relevant professional standards and guidance issued by the Financial Reporting Council and the Institute and Faculty of Actuaries, including *Transformations Technical Actuarial Standard* (as published in December 2010), *Insurance Technical Actuarial Standard* (as published in October 2010), *Technical Actuarial Standard D: data* (as published in November 2009), *Technical Actuarial Standard M: modelling* (as published in April 2010) and *Technical Actuarial Standard R: reporting actuarial information* (as published in November 2009). I have complied with such standards, subject to the principles of proportionality and materiality.

1.46 The Report has been prepared in accordance with the PRA's Statement of Policy on its approach to insurance business transfers (the "PRA Statement of Policy") and with Chapter 18 of the supervision manual ("SUP 18") contained in the FCA Handbook.

2. REGULATORY BACKGROUND

Introduction

2.1 In this section I describe the UK and Italian general insurance markets and the regulatory regimes in each country.

Overview of the UK Insurance Market

BACKGROUND

2.2 UK insurers, as well as other financial services organisations, are regulated by both the PRA and the FCA using a system of dual regulation. Between them, the PRA and the FCA have approximately 3,500 employees and an annual budget of over £600 million. The PRA and the FCA are statutory bodies set up under the Financial Services Act 2012 ("FinSA").

2.3 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.

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

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

2.5 A Memorandum of Understanding ("MoU") has been established between the PRA and the FCA, which sets out the high level framework by which the two new regulatory bodies will co-ordinate. In particular, the MoU requires the PRA and FCA to co-ordinate with each other in advance of insurance business transfers under Part VII of FSMA.

2.6 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.

2.7 The FCA is concerned with achieving fair outcomes for consumers and seeks to ensure that firms adhere to its conduct principles. Its operational objectives 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.

2.8 For the purposes of the Report where I refer to the "Regulator" this should be taken to refer to the PRA and/or the FCA (or their predecessor body, the Financial Services Authority, “FSA”) as appropriate.

TAXATION

2.9 In the UK, general insurance companies are taxed on profits achieved at the main rate of corporation tax (which, from 1 April 2015, is 20%).

FINANCIAL SERVICES COMPENSATION SCHEME

2.10 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. Insurance protection exists for private policyholders and small businesses (those with an annual turnover of less than £1,000,000) 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 wind-up under compulsory insurance (such as motor third party liability cover) and 90% of the claim incurred before the wind-up for non-compulsory insurance (such as home insurance, or the non-compulsory parts of motor insurance), without any maximum. The FSCS is funded by levies on firms authorised by the Regulator.

FINANCIAL OMBUDSMAN SERVICE

2.11 The Financial Ombudsman Service ("FOS") provides private individuals (and micro enterprises[1]) 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.

RISK-BASED CAPITAL FRAMEWORK

2.12 At the end of 2004 the FSA introduced a risk-based capital framework (known as the ICAS framework) under which companies are required to assess solvency under two regimes, referred to as Pillar I and Pillar II. This framework is now supervised by the PRA.

Pillar I

2.13 Under ICAS Pillar I, each insurer has both to meet statutory requirements based on EU Directives and to provide a more risk-based enhanced capital requirement ("ECR") calculation to the PRA. This includes setting up Technical Provisions in accordance with those Directives and having sufficient available capital to meet at least the Minimum Capital Requirement ("MCR"). Composites calculate separate ECRs and MCRs for their long-term and general insurance businesses; those relating to general insurance business can only be met by assets outside of the long-term funds, although capital resources arising outside the long-term funds may be allocated towards long-term business.

2.14 Details of the calculation of the MCR as it relates to general insurance are given in Appendix E but essentially it comprises the greater of a premium measure, a claims measure, a prior year MCR measure, and a minimum amount, currently set at €3.7 million. The ECR is the sum of an asset charge, a premium charge and a charge for technical provisions less the claims equalisation reserve ("CER"). Insurers are not required to make publicly available their ECR calculation and supporting documentation insofar as it relates to non-life insurance. For long-term insurance business, insurers are required to show the ECR on Form 2 of their returns to the PRA.

2.15 The Technical Provisions required under the EU Directives as relating to general insurance business are:

- The unearned premium provision ("UPR") – the UPR is the amount set aside from premiums written before the valuation date to cover risks incurred after that date;
- The additional amount for unexpired risk ("URR") – the URR is the amount held in excess of the UPR, to allow for any expectation as at the valuation date that the UPR will prove to be insufficient to cover the cost of claims and expenses incurred during the period of unexpired risk; and
- The claims outstanding provision – the reserve set up in respect of the liability for all outstanding claims at the valuation date, whether reported or not.

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

2.16 The UPR is typically calculated on a daily basis (but alternative methods may be acceptable where the daily basis is not appropriate) and makes no allowance for the time value of money (i.e. discounting).

2.17 The claims outstanding provision typically comprises the case reserves plus the amount, if any, for claims incurred but not reported ("IBNR") at the valuation date. Case reserves are the amounts estimated on a case-by-case basis as being required to settle reported (open) claims. The IBNR reserve is the amount estimated as being required to provide for:

- claims still to be reported to the insurer as at the valuation date which related to claim events that have occurred before that date; and
- any perceived shortfall between the projected ultimate costs and the case estimates for claims already notified, although occasionally this provision is shown separately where it is often referred to as an "incurred but not enough reported" ("IBNER") reserve. The IBNR (and IBNER) reserves would typically be evaluated using statistical techniques based on grouped data.

2.18 Under UK regulatory practices, only in particular limited circumstances may the claims outstanding provision estimate include any allowance for the time value of money. Therefore, all other things being equal, a margin exists in the provision to cover (at least in part) unexpectedly adverse claims development.

Pillar II

2.19 The capital that must be held under ICAS Pillar II is an amount based upon the Individual Capital Assessment ("ICA"), which is the company's own assessment of its capital requirements. Pillar II is intended to provide a more realistic and complete view (than is provided by the MCR under Pillar I) of the risks to which the company is exposed, and to provide a framework within which the company should be managed. The separate management of the long-term and general insurance businesses within composites necessitates these entities to prepare separate ICAs for the two business types.

2.20 The PRA requires each insurer, when preparing its ICA, to identify the major risks it faces and, where capital is appropriate to mitigate those risks, to quantify how much (and what type) of capital is appropriate. The PRA expects each insurer to conduct stress tests and scenario analyses in respect of each risk. The capital requirements so determined are then aggregated, allowing for diversification between risks where appropriate. These stress tests and scenario analyses, together with the supporting analysis, must be documented and, along with the results, submitted to the PRA (on request) as the ICA. The insurer is not required to publish its Pillar II capital requirement.

2.21 For the ICA, an insurer will assess the amount of capital it needs to hold to remain able to meet its liabilities as they fall due to a level of certainty prescribed by the Regulator – the level of capital so determined is intended to ensure that an insurer is less than 0.5% likely to become insolvent, allowing for one year's trading (or the equivalent percentage over a longer new business period) and the subsequent run-off to extinction of the liabilities.

2.22 As stated above, ICAS Pillar II financial information is not published and remains private between the PRA and the company. I have therefore reviewed this information and have commented on it in general terms, but I have not included any ICAS Pillar II figures in the Report.

2.23 The PRA will review the ICA periodically and may prescribe an additional amount of capital that must be held by the insurer in addition to the ICA. The total amount of Pillar II capital prescribed by the PRA is called Individual Capital Guidance ("ICG"). The ICG is usually set as a percentage of the ECR, gross of CER. The ICG is not published and details of this remain private between the insurer and the PRA.

2.24 The PRA has indicated that ICG will be given taking into consideration capital resources consistent with at least a 99.5% confidence level, i.e. a likelihood of less than 0.5% to become insolvent) that the insurer will be able to meet its liabilities over a one-year timeframe allowing or, if appropriate to the insurer's business, an equivalent lower confidence level over a longer timeframe.

FCA CONDUCT PRINCIPLES

2.25 As noted above, the FCA is responsible for conduct regulation of all financial firms, including insurers. Rules and guidance for firms are set out in the FCA Handbook. The Handbook includes 11 Principles for Businesses, which are high-level standards that all firms must meet.

2.26 Within its "*Journey to the FCA"* document, the FCA notes that it expects firms to continue to demonstrate that they are achieving the six consumer outcomes set out in an earlier document, published in July 2006 under the auspices of the FSA and entitled "*Treating customers fairly – towards fair outcomes for consumers*" ("TCF"). The aim of this document was to develop Principle 6 of the FSA's Principles for Businesses (PRIN 2.1.1) which stated that each insurer "*must pay due regard to the interests of its customers and treat them fairly*". Principle 7 outlines that each insurer "*must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading*" while Principle 8 states that each insurer "*must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client*".

2.27 The TCF document lists six outcomes that collectively outline insurers' regulatory obligations for the fair treatment of customers. 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.

THE INSURERS (REORGANISATION AND WINDING UP) REGULATIONS 2004

2.28 Under English law, the winding-up of an insurance undertaking is governed by the Insurers (Reorganisation and Winding Up) Regulations 2004. Under these regulations direct insurance creditors have precedence over any claim on the insurance undertaking with the exception of certain preferential claims (e.g. claims by employees, rights in rem etc.) with respect to the whole of the insurance undertaking's assets. Therefore, direct insurance creditors rank ahead of inwards reinsurance creditors and all other unsecured/non-preferential creditors in the event that an insurer is wound up.

Overview of the Italian Insurance Market

BACKGROUND

2.29 Italy is the fourth largest economy in Europe and the fourth largest European insurance market with 2013 premium income of €119bn[2] written by domestic companies and another €7bn[3] on a cross border basis. Seventy per cent of the total market premium was life business, with 30% non-life business. Around 45% of non-life business is Motor Third Party Liability ("MTPL") business. According to the Italian National Association of Insurance Companies ("ANIA"), there were 132 locally established insurance companies operating in 2013 as well as a further 59 selling on a cross border basis.

THE CURRENT REGULATORY REGIME IN ITALY

2.30 Insurance companies in Italy are licensed and regulated by the Institute for Insurance Supervision (in Italian "Istituto per la Vigilanza sulle Assicurazioni") better known as "IVASS". IVASS was formed on 6th July 2012, replacing the previous body, ISVAP and assuming all its powers and responsibilities. The aim of this change was to have a closer link to the regulation of the banking sector. IVASS is an autonomous state institution and falls under the supervision of the Banca d'Italia.

2.31 Italian insurance companies are required to hold solvency capital in accordance with the EU Solvency I Directive (see Appendix E). Under these regulations, assets are valued broadly at amortised book value, and reserves are calculated on a prudent basis. When solo entity solvency is assessed some allowance for unrealised gains on assets is permitted. There is no statutory requirement to hold capital similar to the UK's (ICAS framework) Pillar II requirements in Italy. However, generally IVASS will require companies to hold in excess of 100% of the statutory minimum solvency margin and will regularly give guidance to individual companies on the solvency level it expects.

2.32 There is a requirement for Italian insurers to have proper risk management and governance in place and to report on this to IVASS and the governing bodies of the insurance company. This was originally defined in 2008 and covers internal controls, internal audit, the need to have a risk management function and regular risk reporting.

2.33 The main law governing insurance in Italy is the Code of Private Insurance (legislative degree 209 of 7th September 2005), which includes among other items, those outlined below.

Motor Third Party Liability Insurance

2.33.1 In common with other European countries it is compulsory to have MTPL insurance in order to drive on public roads in Italy. Qualifying insurance must have cover for personal injury of at least €5m per claim, regardless of the number of victims and at least €1m for material damage.

2.33.2 A unique feature of the Italian MTPL market is the "obligation to insure". This means that any company which is authorised to write MTPL business is obliged to provide a price and grant cover to any person in the Italian territory who requests insurance.

2.33.3 Companies are obliged to calculate pure premium rates and loadings separately and are obliged to base the premium rates on statistical evidence of past claims experience for a period of at least 5 years. When company statistics are not available it is permissible to use market data. Companies are obliged to communicate their MTPL tariff to IVASS as well as the statistical analysis supporting the tariff. Companies must have an appointed actuary for MTPL who must review and approve the methods used to calculate the premium and reserves.

[2] According to figures produced by Insurance Europe

[3] According to figures produced by the Italian National Association of Insurance Companies)

National Guarantee Fund for Road Accident Victims

2.33.4 The National Guarantee Fund for Road Accident Victims pays compensation for damages caused by motor vehicles and craft for which insurance is compulsory, but where the vehicle is uninsured or certain other circumstances including:

- the accident has been caused by an unidentified vehicle/craft;
- the vehicle/craft is uninsured;
- the vehicle/craft is insured via an undertaking providing insurance by way of establishment or of free provision of services, which has been placed under compulsory winding up at the time of the accident or otherwise;
- the vehicle has been used against the will of the owner; or
- the accident has been caused by a foreign vehicle bearing a registration plate which does not correspond or no longer corresponds to the vehicle.

Consumer Protection

2.33.5 IVASS is charged with consumer protection and does this through requirements on transparency and minimum service standards for claims settlement. Furthermore, dispute resolution is performed by IVASS.

2.33.6 Under Italian law, in compliance with the Regulation ISVAP n. 24 of 19 May 2008, insurance companies shall receive and manage complaints referred to them, even when they concern subjects involved in the company's operational cycle, and reply to the complainant within 45 days of receiving them.

2.33.7 When the complaint concerns the management of the contractual relation, and in particular the assignment of liability, the provision of the benefit, the quantification and payment of the amounts due to the person entitled, the complainant shall send it directly to the company. In these cases, if the complaints do not receive any reply within 45 days or receive an unsatisfactory reply the complainant can apply to IVASS.

2.33.8 In the case of complaints submitted directly to IVASS, the supervisor shall forward the complaint to the company (within 90 days of receipt) and, at the same time, shall inform the person concerned. The company shall send its reply directly to complainants within 45 days of receiving the complaint. Moreover, during the preliminary inquiry IVASS may ask for data, information or documents not only to the complainant but also to supervised entities, which shall reply within 30 days of receiving such request.

Intervention and winding-up legislation

2.33.9 When an Italian insurance undertaking fails to comply with applicable regulations concerning technical provisions and assets covering technical provisions, IVASS must notify the undertaking of the breach and require it to be corrected within a defined timescale as well as preventing the disposal of assets. If the breach of regulations is not addressed within this timescale IVASS can take a number of additional steps, including appointing an administrator, preventing the writing of business and freezing of assets.

2.33.10 When a company does not have an adequate level of Solvency Margin, IVASS will require a restoration plan to be submitted within a reasonable timeframe (not being detrimental to the interests of the company's insureds).

2.33.11 IVASS may also intervene when a company's financial position is deteriorating in such a way that the security of the insureds is threatened and require a recovery plan to be implemented.

2.33.12 IVASS may freeze assets and may require mortgages to be put on real estate assets in favour of insurance or reinsurance claims.

2.33.13 Under severe circumstances (serious irregularities with respect of insurance law or prospect of serious financial losses), IVASS may request the Ministry of Economic Development to place a company under special administration. The insurance law sets out the powers of the administrators and their responsibilities which are both extensive.

2.33.14 IVASS also has powers in certain circumstances to request the Ministry of Economic Development to order a compulsory winding up of a company and/or the court to declare its insolvency. In the case of a winding-up, claims from insurance policies generally have priority over other claims on the assets backing the Technical Provisions representing these insurance policies, separately for life and non-life business. However, the precedence given to creditors is governed by general bankruptcy law.

2.33.15 To safeguard insurance policies in the case of a winding-up, all insurance undertakings are required to keep a special register showing the assets representing the Technical Provisions for life and non-life business. The amount of such assets must at any time be at least equal to the amount of the Technical Provisions, taking account of all the movements recorded.

2.33.16 The assets representing the Technical Provisions written in said register are exclusively set aside for the fulfilment of the undertaking's obligations arising out of the contracts to which the provisions are referred. Assets so provided are segregated from the other assets held by the undertaking and not written in said register.

TAXATION

2.34 In Italy, corporation tax is levied on the taxable income of the insurer as determined under Italian GAAP accounting standards. There are two main components to the corporation tax, IRES at 27.5% plus IRAP at a standard rate of 3.5%. IRAP rates vary by type of business; the standard rate for insurance companies is 5.3%. IRAP is, however, levied on a regional basis and regions are allowed to increase or decrease the standard IRAP rate by up to 0.92%.

Differences between the UK and Italy

CAPITAL AND RESERVE REQUIREMENTS

2.35 The main difference between the prescribed capital rules in the UK and those in Italy is that Italian regulations do not require the calculation of Pillar II capital (under the ICAS framework). The result of this difference is that the Italian regime is generally less onerous than the UK Pillar II requirements (under the ICAS framework).

2.36 The outstanding claim reserve and unearned premium reserve calculation requirements, being based on the same EU directives, are generally consistent between the UK and Italy. Italian insurers must hold Technical Provisions as described in paragraphs 2.15 to 2.17 above and these must not be discounted for the time value of money. As per the UK, the choice of actuarial methods used by Italian insurers to determine reserves is not prescribed, but left to the judgement of the insurer.

2.37 Equalisation Provisions must be established by Italian insurers to equalise fluctuations in loss ratios in respect of credit insurance and natural catastrophes for other non-life business lines.

2.38 Notwithstanding the above, all EU insurers must implement a new solvency regime, known as Solvency II (see paragraph 2.47 below) from 1 January 2016. This will have the effect of putting regulatory capital and reserve requirements in the UK and Italy onto essentially the same basis.

SECURITY UNDER WINDING-UP

2.39 In the event of the winding up of an insurance company under Italian regulations, insurance claims take absolute precedence over any other claim on the insurer, with respect to assets representing the Technical Provisions (subject to certain rules).

2.40 In the event of the winding up of an insurance company under UK regulations, claims of direct insurance creditors take precedence over any other claim on the insurer (including those of inwards reinsurance creditors), with the exception of certain preferential claims (e.g. claims by employees), with respect to the whole of the insurance company's assets.

2.41 It follows therefore that in the case of a winding-up of an insurance company where there are sufficient assets to cover the Technical Provisions the Italian regime in respect of the priority of insurance debts generally would be expected to be at least as favourable to policyholders and beneficiaries as the UK regime.

2.42 Conversely, in the situation of a winding-up of an insurance company where there are insufficient assets to cover the Technical Provisions, the UK regime (giving priority of direct insurance debts) would be expected to be at least as favourable to policyholders and beneficiaries as the Italian regime.

2.43 The comparative position of policyholders in a UK insurer versus policyholders in an Italian insurer in a winding up situation is therefore a function of the assets available (and their size relative to the Technical Provisions) and the proportion of inwards reinsurance business relative to direct business.

CONSUMER PROTECTION

2.44 In the UK, the FSCS compensates eligible customers of authorised financial firms (including insurers) in the event that the firm has insufficient assets to meet claims; and the FOS provides eligible customers with a free, independent service to help settle disputes with financial firms (including insurers). There are no direct equivalent bodies in Italy, although the National Guarantee Fund for Road Accident Victims provides some of the cover of the FSCS, and IVASS helps customers to settle disputes with financial firms (including insurers).

2.45 With regard to consumer complaints, both the FOS in the UK and IVASS in Italy require customers to have complained to the firm in the first instance and will look into complaints if either the firm does not respond to the complaint or the customer is not satisfied with the response. Both the FOS and IVASS will investigate complaints free of charge to the complainants. Where complaints are brought to the FOS, they are reviewed by an adjudicator who will make a decision which the parties will have a two week period to respond to. If either party disagrees with the decision, the complaint is referred to an Ombudsman whose decision is final on the firm. The FOS can make a monetary award of up to £150,000 (excluding costs and interest).

2.46 Where complaints are investigated by IVASS, in most cases IVASS will require the firm to respond to the complainant, and forward a copy of its response to IVASS in order for the latter to assess its contents. If the contents of the firm's answer to the complainant are complete and correct the complaint procedure is considered closed and no further communication is necessary. Otherwise, if the undertaking's answer is incomplete or incorrect, IVASS provides appropriate information to the complainant at the closing of the investigation. Whilst IVASS does not have powers to make monetary awards of compensation like FOS, if it finds out that there has been a breach of rules by the supervised entities, it can start a sanctioning procedure (of an administrative, pecuniary or disciplinary nature), and gives information on its outcome in its bulletin and on its internet site.

Solvency II

2.47 The regulatory solvency reporting requirements for EU insurers and reinsurers will undergo a major change with effect from 1 January 2016, as they will need to meet the requirements of a new solvency regime developed by the European Commission. While the formal date for full implementation of these new rules is 1 January 2016, there will be transitional arrangements during which insurers and reinsurers need not meet all of the minimum solvency requirements (subject to approval by the local supervisor).

2.48 This new regime is referred to as Solvency II and aims to introduce solvency requirements that reflect better than the existing solvency regimes the risks that insurers and reinsurers actually face and to introduce consistency across the European Union. UK companies will be required to adhere to a set of new, risk based capital requirements and, in contrast to the position under the current UK Pillar II requirements, some of the results will be shared with the public.

2.49 EU member states were required to transpose the Solvency II Directive into national legislation by 31 March 2015. In the UK this transposition was indeed completed during March 2015:

- the PRA incorporated the provisions of the Solvency II regime into the PRA Rulebook; and
- HM Treasury published the Solvency 2 Regulations 2015 which, together with FSMA, implement the Solvency II Directive into UK legislation and establish a regulatory system for operating the Solvency II regime.

2.50 A law changing the Insurance Code to fully implement Solvency II was presented to the Italian Parliament during March 2015 and will now go through the various steps to be transposed fully into law.

2.51 Solvency II will be a principles-based regime and will be based on three 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 permanent 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.

2.52 The SCR under Solvency II is the amount of capital required to ensure continued solvency over a 1 year time frame with a probability of 99.5%. There are two main approaches to calculating the SCR:

(1) 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

(2) 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 plain terms, 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.

2.53 The Minimum Capital Requirement under Solvency II ("MCR_2"), which will be lower than the SCR, defines the point of intensive regulatory intervention. The MCR_2 calculation is more formulaic and less risk sensitive than the SCR calculation.

3. BACKGROUND ON RSAI AND SIO

RSAI

INTRODUCTION

3.1 RSAI is an insurance company, registered as a public limited company in England and Wales (registered number 93792) under the Companies Act 2006. It is an indirectly wholly owned subsidiary of RSAIG, which itself is registered as a public limited company in England and Wales (registered number 2339826) under the Companies Act 2006. RSAIG is the ultimate holding company of a multinational insurance group currently operating in 25 countries and covering risks in over 130 countries, with the vast majority of the business being written in the UK, Scandinavia and Canada.

3.2 RSAI is the largest insurance operation in RSAIG. It is jointly regulated by the PRA and the FCA, and is authorised to write general insurance and reinsurance business. The active business of RSAI is written largely in the UK, but also in Belgium, France, Germany, Italy, the Netherlands and Spain.

3.3 RSAI's issued and fully paid share capital as at 31 December 2014 was made up of 4,859,811,537 ordinary class A shares of 25p each and 1 ordinary class B share of US$1.

3.4 In 2011, RSAIG ran a programme of Part VII transfers as part of its preparations for Solvency II (i.e. to achieve capital efficiencies and simplify the supervision of RSAIG in the UK under Solvency II). This programme involved moving from 22 UK regulated entities down to 5, namely – RSAI, SIO, The Marine Insurance Company Ltd ("Marine"), Royal & Sun Alliance Reinsurance Limited ("RSA Re") and BAIC. The transfers became effective from 1 January 2012.

3.5 Specifically in Italy, the programme involved the Italian branch of Royal International Insurance Holdings Limited ("RIIH") being transferred to the (then newly formed) Italian branch of RSAI, and the transfer of two Italian branches from National Vulcan Engineering Insurance Group Limited ("National Vulcan") and The Sea Insurance Company Limited ("The Sea") respectively to the Italian branch of SIO. The transfers involved an operational change within RSAIG, but had no impact on continuity.

3.6 The Italian branch of RSAI is based in Genoa and writes multinational business.

CUSTOMER RELATIONSHIPS

3.7 RSAI's business is sourced mainly through the following distribution channels:

3.7.1 Personal lines:

- Direct to customer via the MORE TH>N brand (including MORE TH>N Business, RSAI's direct commercial offering);
- Affinity schemes (e.g. Tesco Pet) where the customer relationship is "controlled" by the affinity partner;
- Broker business, primarily via brand broker panels (e.g. AA, Kwik Fit) where the customer relationship is "owned" by the broker.

3.7.2 Commercial lines, offering traditional property/liability/motor insurance via three routes to market:

- Small Medium Enterprises via smaller brokers;
- Mid-market for larger enterprises via larger brokers; and
- Global which includes the Risk Solutions business for multi-national clients, written from the UK, Belgium, France, Greece, Germany, Italy, the Netherlands and Spain, placed via global brokers, the Marine portfolio which is written on an international basis via brokers and Construction, Power & Engineering.

3.7.3 Commercial lines also participate in Delegated Authority arrangements where policy administration and claims handling are delegated with reporting on a bordereau basis.

3.8 RSAI has approximately 4.1 million policyholders, and the level of data it holds on them varies by nature of the customer relationship.

3.9 The business of the Italian branch of RSAI is made-up of large and speciality commercial risks, which is sourced exclusively from brokers. At the date of this Report, there are approximately 350 policies in-force.

BUSINESS WRITTEN

3.10 The main elements of the business written by RSAI are as follows (percentages in brackets are the proportions of total gross premiums written in 2014 which total £3,896 million[4]):

- Personal Lines Motor (9%);
- Personal Lines Household (20%);
- Personal Lines Financial Loss (8%);
- Commercial Lines Motor (16%);
- Commercial Lines Property (22%);
- Commercial Lines Liability (11%);
- Marine (4%);
- Goods-in-Transit (5%)
- Accident & Health (1%); and
- Inwards Treaty Reinsurance (4%).

3.11 The main elements of the business written by the Italian branch of RSAI are as follows (percentages in brackets are the proportions of total gross premiums written in 2014 which total €17.7 million[5]):

- Property (63%);
- Liability (15%);
- Engineering (15%);
- Marine (7%).

KEY FINANCIAL INFORMATION

3.12 As at 31 December 2014 the gross outstanding claim reserves within RSAI were £5,101 million[6], comprising:

- Personal Lines Motor (12%);
- Personal Lines Household (3%);
- Commercial Lines Motor (13%);
- Commercial Lines Property (12%);
- Commercial Lines Liability (45%);

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[4] Based on Column 1 of Form 20A of RSAI's Returns to the PRA as at 31 December 2013. It should be noted that the PRA returns includes figures relating to UK subsidiaries of RSAI on a "look-through" basis

[5] Based on Management Account information as at 31 December 2014 (dated 12 January 2015).

[6] Based on Form 20A, line 1, columns 2 & 3, of RSAI's Returns to the PRA as at 31 December 2014

- Marine (5%);
- Goods-in-Transit (2%);
- Inwards Treaty Reinsurance (5%); and
- Other classes combined (3%).

3.13 In addition, as at 31 December 2014, RSAI held a gross provision for unearned premiums of £2,318 million[7] and £81 million[8] in respect of unallocated future claims management expenses. Reinsurers' share of claims outstanding was £901 million[9] and reinsurers' share of unearned premiums was £569 million[10] as at 31 December 2014.

3.14 As at 31 December 2014, the Italian branch of RSAI booked a gross outstanding claim reserve of €35.0 million[11] and a gross provision for unearned premiums of €8.7 million[12].

3.15 As at 31 December 2014, the capital resources of RSAI amounted to £3,278 million[13], compared with a statutory MCR for the business of £1,452 million[14], i.e. the capital resources in excess of regulatory requirements as at 31 December 2014 were £1,826 million. This implied cover for the MCR (capital resources ÷ MCR) of 226% as at 31 December 2014.

3.16 Effective 28 February 2014, RSAI is rated 'A' (stable outlook) by Standard & Poor's and A2 (negative outlook) by Moody's[15].

REINSURANCE

3.17 RSAI has a comprehensive series of reinsurance programmes in place, including excess, stop loss and catastrophe coverage. The intended effect of such reinsurance arrangements, when the other reinsurance arrangements within RSAIG are taken into account, is that RSAIG should not suffer total net insurance losses beyond RSAIG's risk appetite in any one year.

3.18 Reinsurance programmes cover each of RSAI's and RSAIG's main business areas including UK and international property (including catastrophe cover), construction and engineering, professional indemnity and Directors & Officers, surety, marine, motor, casualty and personal accident.

3.19 RSAIG purchases significant catastrophe cover, with all RSAIG's operations required to purchase reinsurance within agreed local reinsurance appetite parameters. RSAIG reviews the operations' proposed catastrophe purchases to check that they at least meet the RSAIG's '1 in 200 year' standard and are also consistent with the required risk based capital. As a result, RSAIG may decide to purchase further catastrophe coverage at the RSAIG level. All catastrophe reinsurance is placed with reinsurers with a Standard & Poor's credit rating of A- or better.

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7 Based on Form 20A, line 1, column 4, of RSAI's Returns to the PRA as at 31 December 2014

8 Based on Form 22, lines 14 and 18, column 3, of RSAI's Returns to the PRA as at 31 December 2014

9 Based on Form 13, Line 61 of RSAI's Returns to the PRA as at 31 December 2014

10 Based on Form 13, Line 60 of RSAI's Returns to the PRA as at 31 December 2014

11 Based on an Excel spreadsheet prepared by RSA Italy showing balance sheets for the Italian branches of SIO and RSAI as at 31 December 2014

12 Based on an Excel spreadsheet prepared by RSA Italy showing balance sheets for the Italian branches of SIO and RSAI as at 31 December 2014

13 Based on Form 1, Line 13 of RSAI's Returns to the PRA as at 31 December 2014

14 Based on Form 1, Line 36 of RSAI's Returns to the PRA as at 31 December 2014

15 http://www.rsagroup.com/rsagroup/en/investor-relations/bond-investor-information/credit-ratings#.U_X63010y7w

3.20 RSAIG has a number of external reinsurers providing the reinsurance protections described above. For the financial year ended 31 December 2014, their share of gross written premiums was £982 million[16] (or 25%). As at 31 December 2014, the major external reinsurers were Lloyd's syndicates, Berkshire Hathaway, Munich Re, Swiss Re, Pool Re, Hannover Re, HDI-Gerling and MO Reinsurance.

INTRA-GROUP REINSURANCE

3.21 As part of RSAIG's restructuring of its regulated insurance operations in the UK (see paragraph 3.4 above), RSAI entered into a series of intra-group reinsurance arrangements to reinsure each of SIO, Marine and RSA Re (individually a "Cedant" and collectively the "Cedants").

3.22 For each Cedant, the reinsurance provided by RSAI covers the entirety of a Cedant's gross insurance liabilities net of collected inuring reinsurance, both past and future, as follows: (i) an Aggregate Excess of Loss reinsurance contract on a funds withheld basis[17] to cover the entirety of a Cedant's insurance business as at 31 December 2011, i.e. all existing inwards insurance business of a Cedant (including any insurance liabilities that were be transferred to the Cedant under the Part VII transfer schemes, effective 1 January 2012, that formed an integral part of the RSAIG's restructuring referred to in paragraph 3.21 above); and (ii) a 100% Quota Share reinsurance contract to cover future (new/renewed) insurance liabilities net of collected inuring reinsurance of the Cedant with effect from 1 January 2012.

3.23 Under the 100% Quota Share arrangement, the Cedant is required to cede, and RSAI is required to accept, 100% of each and every risk (net of collected inuring reinsurance) accepted/acquired by the Cedant which comes within the scope of the treaty. Thus, RSAI shares in the fortunes of each Cedant, receiving 100% of the premium, and is required to pay 100% of losses in respect of each risk ceded.

3.24 Therefore, RSAI reinsures the whole of the business (net of collected inuring reinsurance) for each of SIO, Marine and RSA Re under a combination of Aggregate Excess of Loss reinsurance arrangements (for business in-force as at 31 December 2011) and 100% Quota Share arrangements (for new/renewed business written with effect from 1 January 2012). Specifically for Italy, the Italian branch of RSAI has written an Aggregate Excess of Loss reinsurance arrangement for SIO (covering business in-force as at 31 December 2011) and writes a 100% Quota Share arrangement for SIO (for new/renewed business written post 2011) collectively termed the "SIO Whole Account Reinsurance Arrangement".

RISKS

3.25 RSAI's principal risks and uncertainties are integrated within and managed together with the principal risks of RSAIG (the directors of RSAI being comfortable that an RSAIG approach meets the risk management needs of RSAI).

3.26 For the purposes of managing its risk, RSAIG classifies risk into the following categories: insurance, credit, market, liquidity, operational, reputational and strategic.

3.27 RSAI manages insurance risk (i.e. inappropriate pricing methodologies leading to inadequate premiums; deterioration of reserves; exposure to catastrophes; insufficient reinsurance arrangements; and the risk of increased expenses) through its underwriting strategy, adequate reinsurance arrangements and proactive claims handling as follows:

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

[16] As per RSAI's statutory accounts for the year ended 31 December 2014

[17] Funds withheld is a provision in a reinsurance treaty under which the premium due to the reinsurer is withheld and not paid by the ceding company to enable the ceding company to reduce its potential credit risk to the reinsurer, and/or to retain control over investments. The reinsurer's asset, in lieu of cash, is funds held by or deposited with reinsured companies.

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

3.28 Market risk arises from RSAIG's investment portfolios, and largely comprises changes in interest rates and a fall in the market value of equities and properties. A decrease in the value of the assets backing the insurance contracts could adversely affect the financial position of RSAI to the extent that a movement (in particular, a fall) in asset values is not matched by a corresponding movement in liability values. An RSAIG committee oversees RSAI's investment strategy and sets appropriate risk limits to ensure that no significant concentrations to individual companies or sectors arise.

3.29 The primary sources of credit risk within RSAI are investment and treasury activities and reinsurance counterparty risk. Within the investment and treasury activities, a range of bank counterparty concentration and credit quality limits together with other controls have been put in place to ensure that exposure is managed. New reinsurance cover is placed with reinsurers that are authorised as Approved Reinsurance Counterparties recommended by the RSAIG Reinsurance Credit Committee.

3.30 Liquidity risk is the risk of RSAI being unable to meet its cash outflows without recourse to planned contingent funding. Liquidity is managed such that RSAI maintains a level of cash or cash equivalents or highly liquid assets that can be liquidated within a maximum stated period of time. Contingency funding plans are prepared and monitored to ensure that these minimum levels are met even in stress conditions.

3.31 Operational risks are the risks to which RSAI is exposed to during its day-to-day operations, mainly arising from possible failures of control and external events. RSAI manages operational risk using a range of techniques to identify, monitor and mitigate its operational risk in accordance with RSAIG's risk appetite. These tools include Risk and Control Self Assessments, Key Risk Indicators (e.g. fraud and service indicators), Scenario Analyses and Loss Reporting. In addition, RSAIG has developed a number of contingency plans, including Incident Management and Business Continuity Plans. Quantitative analysis of operational risk exposures material to RSAI is used to inform decisions on the overall amount of capital and the adequacy of contingency arrangements.

3.32 RSAI is exposed to reputational risk, i.e. the current or prospective risk to earnings and capital arising from adverse perception of the image of RSAI (and/or RSAIG) on the part of customers, shareholders, investors or regulators. RSAIG's External Communications team keeps under constant review the threats to RSAI's reputation, both internal and external, and the Risk function works with them to promote a culture of responsibility from front line businesses to the Board. The tools used include a reputational risk register, clear and simple processes, training, external threat and perception monitoring and crisis management plans.

3.33 RSAI is exposed to strategic risk, i.e. the current or prospective risk to earnings and capital arising from adverse business decisions, improper implementation of decisions or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organisation's strategic goals, the business strategies developed to achieve those goals, and the quality of implementation. The strategic risk profile of RSAI is kept under continuous review by the RSAIG Executive Committee and forms a key element of quarterly Board Risk Committee meetings.

3.34 Pension risks are the risks to which RSAI is exposed to in relation to its final salary pension scheme(s). The funding position of the RSAI pension scheme(s) is sensitive to the assumptions made from time to time (including inflation, interest rate, investment return and mortality) to determine its long-term liabilities relative to the corresponding market value of the pension fund's assets. In particular, the financial position of the RSAI pension fund is highly sensitive to changes in bond yields and will also be impacted by changes in equity markets.

3.35 RSAI/RSAIG is seeking regulatory approval to use an internal model to calculate the SCR under Solvency II. There is a risk that the regulator(s) may elect not to give approval for the whole, or parts, of the model. This may mean that RSAI/RSAIG would need to use elements of the standard formula for calculating the SCR, which may be materially different to the SCR using the internal model. RSAI/RSAIG maintains close and regular dialogue with its regulators throughout the internal model approval process ("IMAP") as part of its management of regulatory capital risk.

CAPITAL POLICY AND APPETITE

3.36 RSAIG's and RSAI's objective is to maintain sufficient capital, which comprises shareholders' equity and subordinated loan capital, to meet its plan and objectives. This represents sufficient surpluses for both regulatory and economic capital, as well as sufficient capital to support RSAIG's and RSAI's aim of maintaining single 'A' ratings (see paragraph 3.16 above). To assist in managing its capital position, RSAIG has set internal target coverage ratios for each of the principal capital measures.

3.37 RSAI holds appropriate levels of capital to satisfy UK regulations. As at 31 December 2014, RSAI had a Solvency I surplus of £1.8 billion and a coverage ratio of approximately 2.3 times (see paragraph 3.15 above).

3.38 Economic capital is RSAIG's preferred measure of capital sufficiency. It is RSAIG's own assessment of the amount of capital it needs to hold to meet its obligations given RSAIG's risk appetite. Assets and non-insurance liabilities are valued on an economic basis providing a realistic representation of RSAIG's financial position.

3.39 The economic capital model compares available capital with the economic capital assessment ("ECA"). Available capital is the capital (over and above the IFRS insurance liabilities) that is available to absorb losses. It includes subordinated debt, but excludes items such as goodwill and other intangible assets, deferred tax items and pension scheme surpluses and deficits. ECA is the capital required at a confidence level equivalent to a Standard & Poor's long term 'A' rated bond default curve. As at 31 December 2014, the RSAIG's surplus economic capital calibrated to Standard & Poor's long term 'A' rated bond default curve was approximately £0.9 billion.

3.40 The economic capital model is also used for RSAIG's ICA, the only adjustment made being the use of the PRA's required calibration (see paragraph 2.24 above).

3.41 RSAIG and RSAI received their latest ICG (based on their ICA submission) from the PRA in February 2014 and at the request of the PRA it remains confidential.

FAIR TREATMENT OF CUSTOMERS – TCF

3.42 In the UK, RSAIG has set up a TCF Framework in order to ensure that fair outcomes are delivered to customers. The key components of this framework are culture, governance, management information, customer dedication assessments and assurances.

3.43 Staff in the UK must complete mandatory TCF training, with managers being provided with guidance on applying the principles of TCF. Staff surveys are carried out to measure the success with which key TCF messages are being received by staff. Staff rewards are partly based on the performance against TCF objectives.

3.44 There are processes in place to ensure that the fair treatment of customers is achieved, including regular monitoring and rectification of any shortcomings that are identified.

3.45 The Board of RSAIG has overall responsibility for ensuring that UK TCF objectives are met. Additionally, RSAIG has adopted a "customer obsession" initiative which applies the philosophy of doing the best by all of its customers across all the global territories in which it operates.

SIO

INTRODUCTION

3.46 SIO is an insurance company, registered as a private limited company in England and Wales (registered number 14644) under the Companies Act 2006. SIO is the oldest constituent member of RSAIG. Formerly known as the Sun Fire Office, SIO was founded in 1710 and was incorporated in 1891. Until the end of the 19th century SIO only insured against fire.

3.47 In 1959, SIO combined businesses with Alliance Assurance Company Limited under a holding company called the Sun Alliance Insurance Limited. Following this combining of businesses, both Sun and Alliance Assurance Company Limited continued to operate as separate entities.

3.48 In 1965 the holding company Sun Alliance Insurance Limited combined its business with The London Assurance to form Sun Alliance & London Insurance Limited, subsequently known as Sun Alliance and London Insurance plc. However, all three companies, SIO, Alliance Assurance Company Limited and The London Assurance continued to transact business in their own names.

3.49 I am informed that the company accounts dating back to 1922 reflect a number of "agency" arrangements in place in various overseas territories together with a list of branches in the following locations: USA, Canada, South Africa, Australia, New Zealand, Japan, China, Argentina and India. The company has not been able to confirm when all of these branches ceased to transact business; however it would appear that some of the run-off business against a number of these branches was transferred to branches established by the subsequent holding company. In addition some of these branches were sold to other locally domiciled companies.

3.50 The only branch of SIO currently transacting business is its Italian branch, which trades under the RSA brand. This branch was established in 1925 and is currently based in Genoa, with an office in Milan. This branch remains the only active underwriting branch of SIO.

3.51 SIO received the entire Italian branch businesses of National Vulcan and The Sea via transfers under Part VII of FSMA effective 31 December 2011, as part of RSAIG's restructuring of its regulated insurance operations in the UK (as outlined in paragraph 3.4 above).

3.52 The business transferred to SIO from National Vulcan and The Sea comprised contracts of insurance written and issued by the Italian branches of National Vulcan and The Sea made-up of Engineering and primarily Marine business respectively.

3.53 As referred to in paragraph 3.22 above, SIO and RSAI entered into two reinsurance arrangements that cover the entirety of SIO's gross insurance liabilities net of collected inuring reinsurance, both past and future, as follows: (i) an Aggregate Excess of Loss reinsurance contract on a funds withheld basis to cover the entirety of SIO's insurance business as at 31 December 2011, i.e. all existing inwards insurance business of SIO (including the insurance liabilities of National Vulcan and The Sea); and (ii) a 100% Quota Share reinsurance contract to cover future (new/renewed) insurance liabilities net of collected inuring reinsurance of SIO with effect from 1 January 2012.

BUSINESS WRITTEN

3.54 The SIO portfolio (i.e. the Italian branch) consists of Personal and Commercial lines business, the main classes being motor, property, general liability, engineering and bond business:

- MTPL is the largest class written with the potential for claim resolution to take up to 10 years;
- Property risks written are short-tail with incidental exposure outside Italy;
- General liability risks are generally third party and mainly written on a loss occurrence basis;
- Engineering consists of renewable policies which are mainly electronic equipment, machinery breakdown, bodily injury and contractors' plant and machinery and non-renewable policies mainly consisting of erection all risk and contractors' all risks;
- Bond business, relating mainly to bonds put up by the contractors tendering for public projects that are forfeited if, on being awarded a contract, they opt not to take it up.

3.55 The vast majority of business is produced through either agents or brokers. Circa €700k of premiums (out of approximately €230m) is written directly with policyholders.

3.56 The business written by SIO (the Italian branch) therefore includes the presence of some longer-tail liabilities within the motor and general liability classes.

KEY FINANCIAL INFORMATION

3.57 As at 31 December 2014 SIO held gross Technical Provisions of £354.0 million, with reinsurers' share of these reserves booked at £354.0 million. Therefore, SIO held zero net claims reserves as at 31 December 2014[18]. These gross Technical Provisions comprised £98.8 million for unearned premiums, and £255.2 million for claims outstanding. SIO did not hold or any equalisation provision.

3.58 The main elements of the business written by SIO are as follows (percentages in brackets are the proportions of total net premiums written in 2014, before intra-group reinsurance with RSAI, which total €232.7 million[19]):

- Personal Lines Motor (42%);
- Personal Lines Property (8%);
- Personal Lines Liability (2%);
- Personal Accident (5%);
- Commercial Lines Motor (5%);
- Commercial Lines Property (17%);
- Commercial Lines Liability (6%);
- Engineering (7%);
- Marine (4%);
- Bonds (2%); and
- Accident & Health (2%).

3.59 As at 31 December 2014, the total capital resources of SIO available to meet its regulatory capital requirements amounted to £59.9 million[20], compared with a statutory minimum capital requirement of £23.5 million[21], i.e. the assets in excess of regulatory requirements as at 31 December 2014 were £36.4 million. This implied a solvency cover ratio (capital resources ÷ MCR) of 255% as at 31 December 2014.

REINSURANCE

3.60 As outlined in paragraph 3.53 above, SIO has entered into intra-group reinsurance arrangements with RSAI that cover the entirety of SIO's gross insurance liabilities net of collected inuring reinsurance, both past and future.

3.61 Since, at least, 2007 excess of loss ("XOL") reinsurance programmes covering SIO, have been placed by RSAIG, including Catastrophe XOL, Marine XOL, Personal Accident XOL and Property & Engineering per Risk XOL. This also includes some Italy (or territories including Italy) specific lower layers. In addition to this, a modest amount of facultative reinsurance is purchased locally. This is either placed directly or via Marsh or Aon in Italy or with Willis in London. The liability (general and motor) and bonds reinsurance is entirely placed locally.

RISKS

3.62 SIO's principal risks and uncertainties are integrated within and managed together with the principal risks of RSAIG that are set out in paragraphs 3.25 to 3.34 inclusive above. The most significant risks are:

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[18] Figures taken from SIO's Annual Report and Accounts for the year ended 31 December 2014

[19] Based on Management Account information as at 31 December 2014 (dated 12 January 2015)

[20] Based on Form 1, Line 13 of the Notes to RSAI's Returns to the PRA as at 31 December 2014 (page 162)

[21] Based on Form 1, Line 36 of the Notes to RSAI's Returns to the PRA as at 31 December 2014 (page 162)

- Insurance risk arising from inappropriate pricing methodologies leading to inadequate premiums; deterioration of reserves; exposure to catastrophes; insufficient reinsurance arrangements; and the risk of increased expenses;
- Market risk arising from adverse movements in market rates and prices, including interest rates, equity prices, property prices and foreign exchange rates;
- Credit risk arising from the company's reinsurers disputing claims, there being defects in contract wording and the possibility of default by its reinsurers; and the non-performance of contractual payment obligations on invested assets and adverse changes in the credit worthiness of invested assets, including exposures to issuers or counterparties for bonds, equities, deposits and derivatives.

3.63 RSAIG (including SIO) uses a range of techniques to manage these risks and reduce its sensitivity to these risks. These techniques include asset liability management strategies, monitoring the financial strength of its reinsurers (including those to whom risks are no longer ceded), and review by external consultants of RSAIG's (and hence SIO's) exposure to long-tail claims such as those arising from Italian MTPL business.

CAPITAL POLICY AND RISK APPETITE

3.64 RSAIG manages the group's operations on a divisional basis. For this reason the directors of SIO believe that use of key performance indicators for SIO is not necessary or appropriate for an understanding of the development, performance or position of the business of SIO with the exception of regulatory solvency.

3.65 SIO holds appropriate levels of capital to satisfy UK regulations. As at 31 December 2014, SIO had available capital on a Solvency I basis of £59.9 million and a coverage ratio of approximately 2.5 times (see paragraph 3.59 above).

FAIR TREATMENT OF CUSTOMERS

3.66 The RSAIG risk appetite which is cascaded to SIO (and all other subsidiaries), includes statements that there will be 'key focus on serving customers well' and 'key focus on putting customers at the heart of everything we do'. This is supported by RSAIG's customer obsession initiative (see paragraph 3.45 above).

4. BACKGROUND ON ITAS

INTRODUCTION

4.1 ITAS originated in the year 1821 to tackle the scourge of fires that were frequent in the cities and countryside, particularly when buildings were made mainly wood. It is a mutual insurance company, registered in Italy (registration number 00110750221). It is incorporated and operates under the laws of Italy.

4.2 ITAS is the parent company of the Gruppo ITAS Assicurazioni (the "ITAS Group"), registered with number 010 in the special register established by IVASS under Regulation no.15 on 20 February 2008. ITAS acts as a head office for a number of subsidiaries as well as being a mutual insurance company with the following features:

- each insured becomes an "insured member" ("socio assicurato" in Italian) and ceases to be a member when insurance cover expires (an exception to this being co-insured policyholders where the coinsurance is not managed by ITAS, and in the case of the Scheme, the policyholders of the Transferring Business, until such time as they renew their policies with ITAS, if they choose to do so);
- the members are the only stakeholders of the company;
- the members participate in decisions of the company; and
- the earnings of the company are invested in services for members and for the community.

4.3 Members benefit from discounted prices on insurance covers and since it has no external shareholders ITAS does not price business to make excessive profits.

4.4 The ITAS Group grew with the acquisition of the life company Edera Vita in 1977 (which in 1996 became ITAS Vita SpA), of Serenissima in 1991 (which became ITAS Assicurazioni SpA) and Val Piave of Belluno, in 1999.

4.5 The ITAS Group has about 660,000 insureds (ITAS about 528,000) with a total of 1.2 million policies. The company has a focus on local investments with over €2 million invested in social and cultural initiatives, sponsorship and donations.

4.6 ITAS has 257 agents, 1,967 associates and agency personnel, 446 employees and 192 members' delegates. I discuss this in more detail below.

GUARANTEE FUND

4.7 Under Italian legislation, mutual insurance companies are required to maintain a Guarantee Fund. Such a Guarantee Fund is provided for in the Corporate By-laws of ITAS (an English language copy of which I have been provided with). The Corporate By-laws specify that the Guarantee Fund should be constituted from contributions from policyholder-members. There is no process to distribute any of the Guarantee Fund to members so it serves as capital to support the on-going business.

4.8 At present contributions are defined as follows:

- For lines of business other than MTPL, contributions to the Guarantee Fund are equal to 5% of the net premium, with a minimum of €5 and a maximum of €40; and
- For the MTPL line there is a fixed amount of €5.

4.9 The increase in the Guarantee Fund from contributions during 2014 amounted to €6.1m. ITAS estimates that contributions will amount to around €7m in 2015 and with the entry of the new members from the Transferring Business contributions will be of the order of €10m per annum from 2016 onwards. The policyholders of the Transferring Business will become members of ITAS on the first renewal post-Scheme, conversely if they do not renew they will never become members.

4.10 The Corporate By-laws of ITAS state that the Guarantee Fund forms part of ITAS's capital and reserves. Accordingly, in situations of financial stress, the Guarantee Fund serves as capital to honour the company's liabilities. I note that the Corporate By-laws do not state that any one group of policyholders has any priority call on the Guarantee Fund over any other group of policyholders, and furthermore ITAS has confirmed to me that this is case. As noted in sub-paragraph 2.33.14 above, under Italian law, policyholder liabilities have precedence over other liabilities.

KEY FINANCIAL INFORMATION

4.11 As at 31 December 2014, ITAS held gross claims reserves of €490.8 million, with reinsurers' share of these reserves booked at €23.8 million. Therefore, ITAS held net claims reserves as at 31 December 2014 of €467.0 million[22]. ITAS also held gross reserves for unearned premiums of €177.7 million (including €1.7 million for an unexpired risk reserve), with reinsurers' share of these reserves booked at €6.4 million. Therefore, ITAS held net reserves for unearned premiums as at 31 December 2014 of €171.3 million. In addition, ITAS held an equalisation provision of €1.3 million.

4.12 The main components of ITAS's claim portfolio are listed below together with their respective contributions to ITAS's gross claims reserves of €668.5 million as at 31 December 2014:

- Accident & Health (8%)
- Property (13%)
- MTPL (44%)
- Other Motor (3%)
- General Liability (27%)
- Other (5%)

4.13 The main elements of the business written by ITAS are as follows (percentages in brackets are the proportions of total gross premiums written in 2014, which total €458.6 million[23]):

- MTPL (43%);
- Other Motor (7%);
- Property (22%);
- General Liability (12%);
- Accident & Health (10%); and
- Other (6%).

4.14 As at 31 December 2014, the total capital resources of the ITAS Group available to meet its regulatory (Solvency I) capital requirements amounted to €269.3 million, compared with a MCR of €152.6 million, i.e. the assets in excess of regulatory requirements as at 31 December 2014 were €116.7 million. This implied cover for the MCR (assets available to meet the MCR divided by the MCR) of 176% as at 31 December 2014. As at the same date, ITAS had capital resources of €278.6 million against a MCR of €74.9 million, giving it solvency cover of 372% (on a Solvency I basis).

REINSURANCE

4.15 The reinsurance programme for 2014 included the renewal of the "non-proportional group reinsurance ", which protects the portfolios of ITAS Mutua, ITAS Assicurazioni SpA and for Assicuratrice Val Piave. There is also a proportional treaty covering marine and goods in transit.

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[22] Figures taken from ITAS Mutua's Annual Report and Financial Statements for the year ended 31 December 2014

[23] Based on Management Account information as at 31 December 2014 (dated 12 January 2015)

4.16 The reinsurance programme includes excess of loss, quota share and catastrophe coverage. The programmes covers each of the Group's main lines of business including accident and health, fire, hail, motor and general liability.

4.17 ITAS reinsures - both with proportional and non-proportional covers - ITAS Assicurazioniand Assicuratrice Val Piave. ITAS participates in the profits of reinsurers only for non-proportional treaties (except the MTPL treaty and the hail treaty with ISMEA).

4.18 The ITAS Group has a number of external reinsurers providing the reinsurance covers described above. The major external reinsurers were Hannover Rückversicherung AG (Hannover), Allianz AG (Munich), Mapfre Re Compañia de Reaseguros S.A. (Brussels), DEVK Versicherungen (Cologne), Münchener Rück Italia S.p.a. (Milan), Scor Global P&C Rappresentanza Generale per l'Italia (Milan), Ismea (Rome), Europ Assistance Italia (Milan), Pool RCInquinamento (Milan), Swiss Re Company Rappresentanza per l'Italia (Rome), RGA International Reinsurance Company Limited Rappresentanza generale per l'Italia (Milan), GeneralCologne Re Rappresentanza per l'Italia della Koelnische Rück AG (Milan), Ace European Group Limited, QBE Insurance (Europe) Ltd, and Rappresentanza Generale per l'Italia (Milan).

RISKS

4.19 The ITAS Group has an internal risk management function which regularly assesses the risks faced by the company and the group. The principal risks and uncertainties it faces and its approach to managing these risks is as follows:

- Insurance Risk for the ITAS Group is divided into two main types: underwriting risk and reserve risk. For the former the pricing in Life and Motor TPL is done through statistical studies relating to insurable events. Underwriting itself undertakes the selection of risks process, applying where required, appropriate corrective pricing (e.g. additional premiums). For reserve risk, the ITAS Group companies constantly monitor the development of IBNR reserves (for the non-life business), and the adequacy of the technical bases adopted for the mathematical reserves (for life business). Additional reserves are set when deemed necessary.
- Catastrophe risk – ITAS is exposed to losses from catastrophes relating to earthquakes and floods for the fire line of business and for technological risks. There is also some catastrophe risk from natural events in the "other motor" class. As required under Italian regulation, ITAS provides detailed schedules of its exposures and reinsurance covers in respect of them to IVASS.
- Market risk arises from ITAS Group's investment portfolios, and largely comprises:
  - Interest rate risk: is related to the level and volatility of interest rates. The exposure to this risk mainly concerns the fixed interest securities and in particular those with long durations. For management purposes the interest rate risk is monitored periodically through sensitivity analysis and risk analysis based on Value at Risk for all the portfolios of the companies of the ITAS Group. The investment policy specifies maxima and in some cases minima on the proportions held in interest sensitive instruments, e.g. between 40% and 80% must be in Italian Government bonds;
  - Spread risk: the risk of a change in value due to a deviation of the actual market price of credit risk from the expected price of credit risk. The portfolio is characterized by a conservative approach with a dominance of government stocks. The Group has defined a set of parameters to be observed in the financial management, including a minimum rating and a maximum percentage of debt securities without a rating. The situation of spread risk is periodically monitored with scenario analyses;
  - Equity risk: is the risk of a change in value caused by deviations in market values of equities and/or income from equities from their expected values. The equity component in the portfolio amounted to €135.1 million. Equity risk is monitored periodically through analysis based on Value at Risk, for all companies of the ITAS Group, in accordance with the ITAS Group's Investment Policy. There is a limit of up to 3% of the investment portfolio that can be in Italian equities;

- Real estate risk: this risk is related to the level and volatility of market prices of real estate assets. The real estate assets of the ITAS Group amounted to €259.2 million on a fair value basis as of June 2014. The ITAS Group has a non-speculative policy for the real estate sector. I note that ITAS has recently moved its real estate assets into a property management company, which provides some extra financial flexibility for the individual insurance companies in the ITAS Group;
- Exchange rate risk: this risk depends on the level and/or volatility of exchange rates, and applies to both the assets and liabilities in the portfolio. Non Euro denominated assets are not very significant and amounted to around €7 million for the ITAS Group as of June 2014. I understand there are no material liabilities denominated in currencies other than Euro.

- Liquidity risk: this is the risk of insufficient liquid assets being available when needed to pay claims as they fall due. The ITAS Group has an investment policy with an appropriate asset allocation to deal with this risk; this involves holding assets with a limited duration and that are traded on regulated markets. The investment policy specifies limits for duration for the assets (e.g. between 1 and 8 years for Italian Government bonds). The risk of illiquidity is controlled by having mainly quoted investment in major markets (as at 31 December 2014, only 4.4% of investments were not quoted).
- Credit risk: the risk of a change in value due to actual credit losses deviating from expected credit losses due to the failure of counterparties to meet contractual debt obligations. The ITAS Group manages the level of credit risk through a careful and appropriate policy of selecting of counterparties (e.g. a careful selection of reinsurance counterparties and counterparties with high credit ratings). Credit risk on investments typically arises from holdings in participations (as at 31 December 2014, only 3.2% of rated investments had a rating of less than BBB from S&P).
- Operational risks: ITAS has developed an “Operational Risk Policy” to monitor operational risks which are defined as risks due to inadequate or non-functioning internal processes, personnel, systems or external events. The group regularly maintains policies to define these risks, identify and evaluate them and look at mitigation and management of the risks. This is done using the risk catalogue structure defined in ISVAP regulation n20 of 2008. This defines a 4 level hierarchy involving type of risk, class of risk, category of risk and the risks themselves.

CAPITAL POLICY AND RISK APPETITE

4.20 ITAS has a Risk Appetite Framework (“RAF”) which defines the basis of the risk capacity of the group, and its business model and strategic plan, the risk propensity, risk tolerance and risk limits. The key concepts behind the RAF are as following:

a) Risk capacity: the maximum level of risk which the group can take on without violating regulatory limits or other limits set by the owners or the supervisory authority.

b) Risk appetite: the level of risk (in total and by category) which the Group intends to take on in pursuit of its strategic objectives.

c) Risk tolerance: the maximum deviation from the risk appetite permitted. This limit is fixed at a level such that it is possible to operate, even in stressed conditions without exceeding the risk capacity.

d) Risk profile: the risk effectively assumed, measured at a defined point in time.

e) Risk limits: this is the articulation of risk objectives in the operating limits, defined considering proportionality for each type of risk, line of business or product and type of client

4.21 ITAS's "Risk Appetite Statement" reflects the company's goals to provide cover for its insured members for all the principle insurance needs. This reflects the mutual principles on which it was founded and which are applied also in the other parts of the group. As well as providing cover to the insured members, ITAS wants to remain financially strong and independent and to contribute to its local community. Within this overall principle, ITAS Group furthermore:

- Focuses on individual clients, small and medium enterprises, public entities and looks to expand the base on insured members whilst maintaining the technical balance of the portfolio;
- Exposes itself to market and liquidity risks only when these are in line with the characteristics of its insurance liabilities and with appropriate diversification and prudent management; and
- Minimises residual risk like operational, reputational and regulatory risks.

4.22 The ITAS Group aims to prudently manage its operating capital to maintain an investment grade credit rating so as to have an adequate capital to meet its liabilities. More precisely it's objectives are to have:

- An investment grade credit rating, i.e. BBB- or better from the Standard & Poor's and Fitch or BAA3 from Moody's.
- A Solvency I cover ratio for the group of at least 130%.

4.23 ITAS is redefining its risk tolerance limits ahead of the implementation of Solvency II so that they are related to its solvency under the Solvency II regime as outlined in Section 10.

4.24 As a mutual ITAS does not have access to capital from its shareholders, but can resort to a number of other sources of capital. This includes 4 special members who are corporate bodies which receive a remuneration on the capital paid to ITAS.

4.25 In particular ITAS is in the process of negotiating €60m of sub-ordinated debt from Societe Generale. The terms of this sub-ordinated loan have been agreed and it constitutes Tier 2 capital under Solvency II. The cost of this loan is expected to be less than 5% fixed. For the loan to be in place, final Board and IVASS approval is required and ITAS intends to have that capital in place before the final Court hearing to sanction the Scheme.

FAIR TREATMENT OF CUSTOMERS

4.26 ITAS has an ethical code requiring correctness, honesty and professionalism in all its dealings with its clients. It also has a special committee overseeing the process of customer complaints with the specific role to ensure that the satisfaction of dissatisfied customers is seen as a priority task. ITAS's underwriting policy is designed to provide contracts which meet customers' needs and are fairly priced.

THE ITAS GROUP

4.27 As noted above, ITAS is the parent company of the ITAS Group. There are 3 additional insurance entities within the group, a life insurance and 2 non-life companies. The life insurance business, ITAS VITA SPA ("ITAS VITA"), is 65% owned by the ITAS Group (the residual shares being owned by Hannover Re). The two non-life subsidiaries are Assicuratrice Val Piave SPA (62% owned by ITAS and 24% owned by ITAS VITA SPA) and ITAS Assicurazioni SPA (51% owned by ITAS).

4.28 ITAS VITA is the largest and most significant of the insurance subsidiaries. In 2014 it had a premium income of €422 million and reported a profit after tax of €8.4m on a local GAAP accounting basis. The most important line of business was traditional participating business, accounting for around €350m of premiums, with most of the rest coming from open pension fund business.

4.29 ITAS Vita's carried mathematical reserves (on a Solvency I basis) were over €1.8 billion as at 31 December 2014, with over €1.3 billion arising from traditional participating business and circa €0.5 billion from index/unit linked business.

5. THE PROPOSED SCHEME

Motivation for the Scheme

5.1 As part of the overall RSAIG strategy announced in February 2014, RSAIG would, going forward, focus on its core businesses in the UK, Ireland, Scandinavia, Canada and Latin America. It followed therefore that RSAIG operations in Italy would no longer be considered core businesses and were subsequently sold to ITAS under the terms of the BSTA between RSAI, SIO and ITAS, dated 17 October 2014 (see paragraph 1.6 above).

5.2 The Italian operations of RSAIG comprise RSAI's Italian branch and the Italian branch of SIO. RSAI's Italian branch has around 350 policies in-force and had gross technical provisions of around €44 million as at 31 December 2014. SIO had around 450k policies in force as at 31 December 2014 and held gross technical provisions of €456 million. RSAI, the principle entity in RSAIG has in excess of 4 million policyholders, and as at 31 December 2014 held total gross technical provisions of £7.3 billion.

5.3 An integral part of the BSTA is the proposed Scheme which will enable prior year and current year (2015) policyholders of the Italian branches of RSAI and SIO to transfer to ITAS.

5.4 Accordingly, the Scheme has been formulated to transfer the entire insurance business of the Italian branches of RSAI and SIO to ITAS. To accomplish this transfer the Court's sanction is needed.

Outline

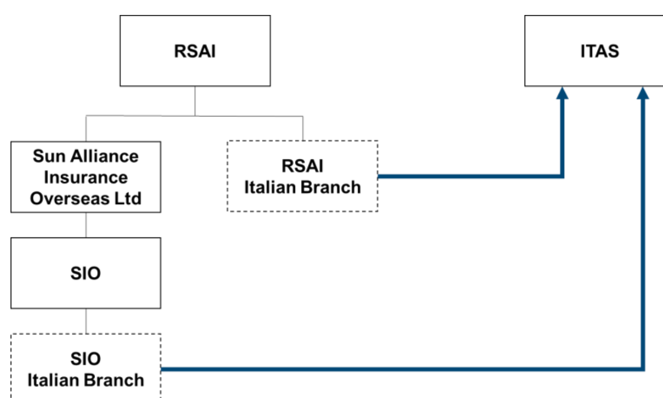
5.5 Under the proposed Scheme all of the insurance liabilities of the Italian branches of RSAI and SIO will move to ITAS. It will also move all external (i.e. outside of RSAIG) reinsurance contracts protecting the Transferring Business.

5.6 The RSAIG reinsurance policies protecting the Transferring Business (including the SIO Whole Account Reinsurance Arrangement) will continue to operate up to the Effective Date. The aforesaid RSAIG reinsurance policies (excluding the SIO Whole Account Reinsurance Arrangement) will close on the Effective Date (in respect of unexpired exposures), but remain in full force and effect following closing in respect of reinsured losses incurred up to the Effective Date (as set-out in the BSTA).

5.7 The SIO Whole Account Reinsurance Arrangement will continue to operate up to the Effective Date, at which point it will auto collapse (i.e. cease to operate).

5.8 The value of the assets (including cash) transferring to ITAS will be equal to the value of the transferring liabilities (net of the transferring reinsurance). The proposed Scheme is illustrated in Figure 5.1 below.

Figure 5.1
Simplified Corporate Structure Pre and Post the Scheme



5.9 The administration (including claims handling) of the Transferring Business of SIO is managed via a self-standing operation and IT platform (see paragraph 1.8 above). The proposed Scheme will not change these arrangements, although I discuss in Section 7 below the possibility of ITAS subsequently integrating the administration of this business with that of its existing business. I also discuss in Section 7 the consequences of the Scheme on the administration of the multinational business written by the Italian branch of RSAI.

5.10 In the unlikely event of there being any policies that cannot be transferred to ITAS under Scheme on the Effective Date, these "Excluded Policies" will be excluded from the Scheme until they can be transferred. SIO's and/or RSAI's net liabilities under these policies will be reinsured by ITAS. It is not currently expected that there will be any Excluded Policies.

5.11 Provided that there are no Excluded Policies, SIO and its Italian branch will be de-authorised following the Scheme. The Italian Branch of RSAI will also be de-authorised.

Effect of the Scheme on the Balance Sheets of ITAS, SIO and RSAI

5.12 Table 5.1 below illustrates how the Scheme is expected to impact the balance sheet of the ITAS Group, based on figures as at 31 December 2014. The "pre-transfer" figures are based on values in the ITAS Group's consolidated financial statements as at that date, allowing for the consideration payable by ITAS for the Transferring Business. The "transferring portfolio" figures are the items in the balance sheets of RSAI and SIO, as at 31 December 2014, that have been identified as relating to the Transferring Business. The post-transfer figures are the sum of the pre-transfer values and those of the transferring portfolio. This illustration is based on the assumption that the transfers takes place as at 31 December 2014 (using an exchange rate of £1.00 = €1.29) and that the assets and liabilities transferred are consistent with Technical Provisions established by RSAI/SIO as at 31 December 2014 (i.e. there is no material change in the valuation basis between RSAI and ITAS).

Table 5.1
Simplified Balance Sheets for the ITAS Group as at 31 December 2014

Figures as at 31/12/14 (€m)	ITAS Pre-Transfer	Transferring Portfolio	ITAS Post-Transfer
Assets			
Investments	2,658	296	2,954
Reinsurer's share of technical provisions	48	38	86
Debtors	121	110	232
Other assets	122	40	162
Cash and equivalents	96	78	173
	3,045	**562**	**3,607**
Liabilities			
Capital resources	322	0	322
Technical provisions	2,129	500	2,628
Financial liabilities	473	0	473
Creditors	61	39	100
Other liabilities	60	23	83
	3,045	**562**	**3,607**

5.13 As the entire Italian branch business of SIO is anticipated to transfer under the Scheme, the balance sheet for SIO post-Scheme will essentially be the shareholder funds remaining at the Effective Date.

5.14 In the case of RSAI, the Transferring Business represents approximately 6% of the gross (of reinsurance) Technical Provisions, and the net impact on the RSAI balance sheet is zero (i.e. the assets transferred are equal to the liabilities transferred). Thus, there is no material change to the RSAI balance sheet as a result of the Scheme.

5.15 Further details of the assets that are within RSAI and ITAS pre and post the proposed Scheme are given from paragraph 10.20 below.

Policyholders Affected

5.16 I have considered the effects of the Scheme on four main groups of policyholders, namely:

- those policyholders of SIO whose policies are to be transferred to ITAS. As mentioned in paragraph 5.10 above, it is not currently expected that there will be any Excluded Policies, and as such there will be no current policyholders of SIO who have policies that are not being transferred;
- those policyholders of RSAI whose policies are to be transferred to ITAS;
- the current policyholders of RSAI who have policies that are not being transferred; and
- the current policyholders of ITAS.

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

Compensation and Complaints

5.18 After the implementation of the Scheme, as with all other insurance companies with an establishment in the UK, RSAI will continue to be required to participate in the FSCS, as it has done since its inception. The Scheme will have no impact on the eligibility of any non-transferring policyholder or group of policyholders of RSAI for compensation under the FSCS.

5.19 As an Italian insurer, ITAS will not participate in the FSCS. The transferring policyholders of RSAI and SIO will therefore lose the protection of the FSCS post-transfer. I discuss the implications of this further in paragraph 7.105 below.

5.20 The Scheme will have no effect on the eligibility of any non-transferring policyholder of RSAI to bring complaints to the FOS. If, as described in Section 2, they are currently able to bring complaints to the FOS, then this will remain the case after the implementation of the Scheme. If they are currently not eligible to complain to the FOS then this will also remain the case after the implementation of the Scheme.

5.21 Given that the Italian branches of RSAI and SIO carry out business from outside the UK, the FOS does not currently have jurisdiction to adjudicate on complaints made by policyholders of the Transferring Business. This fact has been confirmed by the lawyers engaged by RSAI/SIO in relation to the Scheme. The policyholders of the Transferring Business are however currently able to make complaints to IVASS and this will not change as a result of the Scheme. Likewise, the existing policyholders of ITAS, as an Italian insurer, are unable to bring complaints to the FOS, but are able to bring complaints to IVASS, and this will continue to be the case after the implementation of the Scheme.

Administration

5.22 The administration (including claims handling) of the Italian branch business of SIO is currently handled through a self-standing operation and IT platform in Genoa, including:

- Local IT, risk and compliance. Only investment management is centralised at RSAIG;
- Proactive claims management and case reserving practice (undertaken in both Genoa and Milan offices);
- Embedded RSAIG governance processes.

5.23 The administration (including claims handling) of the Italian branch business of RSAI is currently handled through a self-standing operation and IT platform in Genoa.

5.24 I comment on the proposed arrangements for the administration (including claims handling) as they impact policyholder servicing levels post Scheme in Sections 7, 8 and 9.

Capital Policy after the Scheme

5.25 Capital in both RSAI and SIO is currently maintained using a risk-based approach in line with the ICA (explicitly for RSAI and implicitly for SIO via the RSAIG ICA), as set out in Section 2, such that each RSAIG company remains solvent relative to regulatory confidence levels. Whereas, currently capital in ITAS is maintained, as a minimum, using Italy's less onerous Solvency I regime.

5.26 The capital policies outlined in paragraph 5.25 above will be replaced for both RSAI and ITAS by an EU wide risk-based regime following the implementation of Solvency II. The implementation of Solvency II is effective from 1 January 2016.

Approach to Communication with Policyholders

5.27 RSAI, SIO and ITAS have set out the approach that they intend to take in communicating information about the proposed transfer of business to the affected policyholders and other parties.

5.28 The main objectives of the communications are to:

- Give affected policyholders the information that they need to understand the proposed changes;
- Inform affected policyholders about the implications for them of the proposed changes;
- Give affected policyholders access to further relevant information (beyond that in the communications pack);
- Let affected policyholders know what steps they should take if they object to any of the proposed changes;
- Maintain customers' confidence in RSAI, and if the Scheme is sanctioned, ITAS to continue to meet its obligations under transferring and non-transferring policies; and
- Meet legal and regulatory requirements.

5.29 I comment on this proposed approach to communications with policyholders in Section 10.

6. GENERAL CONSIDERATIONS OF THE INDEPENDENT EXPERT

Introduction

6.1 I have compiled my report in accordance with the PRA's Statement of Policy and SUP 18 of the FCA Handbook.

6.2 The PRA's Statement of Policy and SUP 18 require me to consider the terms of the Scheme generally and how the different groups of policyholders are likely to be affected by the Scheme. In particular I am required to give my views on:

- The effect of the Scheme on the security of the policyholders' contractual rights, 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

6.3 After considering the effects of the Scheme on each of the different groups of policyholders affected by the Scheme (as identified in paragraph 5.16 above), I have concluded 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.

6.4 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.

6.5 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. 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 degree of financial security afforded 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

6.6 As noted above, I need to consider the security of policyholder benefits, i.e. the likelihood that policyholders will receive their benefits when due.

6.7 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.

6.8 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;

- Investment strategy;
- Mix of business written; and
- Company strategy – for example, whether it is open or closed to new business.

6.9 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).

Levels of Service provided to Policyholders

6.10 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.

6.11 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

6.12 SUP 18.2.36 and the PRA's Statement of Policy require me, as the 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' contractual rights.

6.13 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' contractual rights.

6.14 In the case of a mutual company involved in the Scheme, I am also required to consider:

- The effect of the Scheme on the proprietary rights of members;
- Whether members will receive compensation under the Scheme for any loss of proprietary rights; and
- The appropriateness of any compensation.

Development of the Scheme

6.15 In the following sections I comment on the Scheme as it will be presented to the Court. During the development of the proposed terms of the transfer I have commented on drafts of the Scheme.

7. THE IMPACT OF THE SCHEMES ON THE TRANSFERRING POLICYHOLDERS

Introduction

7.1 Under the Scheme, the current business of the Italian branches of RSAI and SIO will be transferred from RSAI and SIO to ITAS.

7.2 The main issues affecting the transferring policyholders of RSAI and SIO as a result of the Scheme arise from relative differences in:

- The financial strength of ITAS after the transfer compared with that of RSAI and SIO currently. Financial strength is derived from:
  - the strength of the reserves held;
  - excess assets or capital; and
  - specific financial support arrangements;
- The risk exposures in ITAS compared with those in RSAI and SIO;
- The policy servicing levels provided by ITAS after the transfer compared with those currently enjoyed by the policyholders of RSAI and SIO.

7.3 In this Section I address each of the issues.

The Change in Financial Strength due to the Scheme

RESERVE STRENGTH OF RSAI

7.4 I have been provided with details of the reserves of RSAI as at 31 December 2014, the process by which the reserves are established and details of the internal and external actuarial reviews which have been performed.

7.5 I have not attempted to review in detail the calculations performed by the respective actuaries. Instead I have reviewed the process by which reserves are set, the approach followed by the relevant actuaries, the key areas of reserve uncertainty and the apparent strength of the reserves based on this review.

7.6 The internal actuaries have used generally accepted actuarial methods to estimate reserve requirements (termed “actuarial indications”). From my review of the various documents supporting the reserve calculations I am satisfied that the methodologies, major assumptions and results as at 31 December 2014 appear reasonable.

7.7 The actuarial indications are on a best estimate basis, i.e. not deliberately biased upwards or downwards, and do not include any margins. I interpret this measure to be on a basis higher than a 50% confidence level (as the claim distribution is expected to be positively skewed[24]).

[24] 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.

7.8 The reserves held by RSAI generally are based on the Management's Best Estimates ("MBE"), which in turn are based on the actuarial indications plus an allowance for the various sources of uncertainty surrounding the actuarial indications. I thus consider the MBE to be on a basis stronger than a 50% confidence level. As at 31 December 2014, RSAI reported provisions for outstanding claims of £4.7 billion gross of reinsurance and £3.9 billion net of reinsurance[25]. It also reported a provision for unearned premium reserves of £2.3 billion (£1.7 billion net of reinsurance) and a claims equalisation provision of £0.3 billion.[26].

7.9 I have considered in more detail the treatment of those aspects where I consider the greatest risk of variance currently lays, in particular UK asbestos and UK professional indemnity.

7.10 External actuarial reviews are also performed periodically for (parts of) RSAI's legacy business. The most recent of such reviews were undertaken as at 31 December 2014 for UK asbestos IBNR reserves (by far the largest component of RSAI's legacy reserves). From my review of this report I consider that the external actuaries have employed actuarial methods in line with normal market practice to estimate IBNR reserve requirements for UK asbestos liabilities. While noting that typically there is more uncertainty in reserve estimates for a portfolio of asbestos claims/risks than for most other portfolios of claims/risks, I am satisfied that the methodologies, major assumptions and results as at 31 December 2014 appear reasonable.

7.11 The IBNR reserves estimated by the external actuaries (and adopted by RSAI as their corresponding actuarial indications) have been set using a best estimate approach, i.e. they are not deliberately biased upwards or downwards, and contain no margin for either prudence or optimism, which I consider to be on a basis higher than a 50% confidence level (as the claim distribution is expected to be positively skewed).

7.12 The UK professional indemnity class has seen unfavourable experience recently and as such is being closely monitored by RSAI in 2015, I note that RSAI has introduced a new expected claim development pattern for this account post the third quarter 2014, and that the latest emerging claim data appears to be more in line with expectation.

7.13 RSAI's net (of reinsurance) provision for unearned premiums as at 31 December 2014 was £1.7 billion. It represents the proportion of the premiums written relating to periods of insurance subsequent to 31 December 2014, calculated principally on a daily pro-rata basis. Both time apportionment and risk apportionment bases were used, the method depending on the fluctuation of the incidence of risk. I am satisfied that the method adopted by RSAI for the calculation of the company's provision for unearned premiums to be in line with normal market practice.

7.14 Notwithstanding the fact that RSAI discounts its reserves for asbestos and environmental claims, it does not similarly reflect the time value of money in the estimation of the bulk of its claims reserves. This gives rise to an off balance sheet asset (or margin) equivalent to the time value of money inherent in the undiscounted part of the reserves. Such a margin increases the security of the policyholders.

7.15 RSAI's net (of reinsurance) technical provisions as at 31 December 2014 were £5.9 billion[27], which included £358.1 million (comprising £258.1 million for claims outstanding reserves and £100.0 million for unearned premiums) in respect of the Transferring Business. The Transferring Business therefore represented approximately 6% of RSAI's net (of reinsurance) technical provisions as at 31 December 2014.

Conclusion

7.16 ***Based on my review as described above concerning the reserves of RSAI as at 31 December 2014, the reserves appear reasonable at present.***

RESERVE STRENGTH OF THE ITALIAN BRANCHES OF RSAI AND SIO

7.17 SIO conducts periodic reserve reviews that cover all of its business, including that of the Italian branch of RSAI.

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[25] Per RSAI's statutory accounts as at 31 December 2014

[26] Per RSAI's statutory accounts as at 31 December 2014

[27] Per RSAI's statutory accounts as at 31 December 2014

7.18 I have been provided with an internal actuarial report as at 31 December 2013 on the outstanding claims reserves of the Italian branch businesses of RSAI and SIO. This provides details on the methodologies and assumptions used in setting reserves for this business. I have also been provided with the presentation to the RSA Italy Reserve Committee (which oversees the reserving for the Italian branch businesses of RSAI and SIO) detailing the results of the internal actuarial review as at 31 December 2014. Further, as a bridge between the 2013 and 2014 year-end valuations, I have been provided with an internal actuarial note outlining the methods and assumptions employed for the year-end 2014 valuation and describing any significant changes since the year-end 2013 valuation. In addition, I have been provided with an external actuarial review, as at 31 December 2013.

7.19 I have not attempted to review in detail the calculations performed by the respective actuaries. Instead, I have reviewed the process by which reserves are set, the approach followed to assess the key areas of reserve uncertainty and the apparent strength of the reserves based on this review.

7.20 The internal actuaries have used generally accepted actuarial methods to estimate reserve requirements (termed “actuarial indications”). The actuarial indications are on a best estimate basis, i.e. do not include any margin for prudence or optimism. I interpret this measure to be on a basis higher than a 50% confidence level (as the claim distribution is expected to be positively skewed).

7.21 The reserves held by RSAIG are based on the Management’s Best Estimate (“MBE”), which in turn is based on the actuarial indications (which are intended to be on a best estimate basis) plus an allowance for the various sources of uncertainty surrounding the actuarial indications. The margin (i.e. the difference between the MBE and the corresponding actuarial indication) is set at the Group level. The amount of margin allocated to the Italian branch business of SIO as at 31 December 2014 was circa 3% of the actuarial indication for the net outstanding claims reserves. I thus consider the MBE of the net (of reinsurance) outstanding claims reserve of SIO to be stronger than a best estimate basis, and therefore also stronger than a 50% confidence level. As at 31 December 2014, SIO booked technical provisions, net of reinsurance, of €432.0 million (based on the SIO Whole Account Reinsurance Arrangement ceasing as at 31 December 2014). The net Technical Provisions for the Italian branch of RSAI as at 31 December 2014 were €29.8 million (with no margin allocated to this business, i.e. the MBE of the net of reinsurance outstanding claims reserve was essentially a best estimate basis).

7.22 The Italian branches of SIO and RSAI do not reflect the time value of money in their claims reserves. This gives rise to an off balance sheet asset (safety margin) equivalent to the time value of money inherent in the undiscounted part of the reserves. Such a safety margin increases the security of the policyholders.

7.23 Personal motor third party liability and commercial general liability are the two largest SIO reserving classes, accounting for 37% and 29% respectively of the net outstanding claims reserves booked at €310.1 million as at 31 December 2014. The personal MTPL class has experienced loss ratios of circa 65% for each of the accident years 2012, 2013 and 2014 (improving markedly on the 2011 accident year, which experienced a loss ratio of 74%).

7.24 The commercial general liability book of SIO is characterised by a diverse mix of different lines of business, including Employers Liability, Product Liability and Professional Indemnity, although the underlying mix of business has remained broadly stable over time. The commercial general liability class has experienced loss ratios of circa 82% for each of the accident years 2012, 2013 and 2014 (again improving markedly on the 2011 accident year, which experienced a loss ratio of 93%).

7.25 I also note that the results of the year-end 2014 internal actuarial review of the Italian branches of SIO and RSAI shows the overall claim development for the Accident Years 2013 & prior to have been favourable over the twelve month period to 31 December 2014 as measured by the actuarial indications.

7.26 I am satisfied that the methodologies, major assumptions and results for the outstanding claims reserves of the Italian branches of SIO and RSAI as at 31 December 2014 appear reasonable.

7.27 Of the total net Technical Provisions booked for the Italian branches of SIO and RSAI as at 31 December 2014, €121.9 million (based on the SIO Whole Account Reinsurance Arrangement ceasing as at 31 December 2014) and €7.1 million respectively related to unearned premiums. The provision for unearned premiums was calculated principally on a daily pro-rata basis. Both time apportionment and risk apportionment bases were used, the method depending on the fluctuation of the incidence of risk. I believe the method adopted by Italian branches of SIO and RSAI for the calculation of provisions for unearned premiums to be in line with normal market practice.

7.28 An external actuarial review was also performed on the liabilities of the Italian branches of SIO and RSAI for the purposes of evaluating unpaid loss and allocated loss adjustment expense ("ALAE") reserves as at 31 December 2013.

7.29 The external actuaries have produced a report in accordance with and reflecting the principles contained within actuarial standards TAS-R, TAS-D, TAS-I and TAS-M. The report describes the approach adopted (and the results produced) from their reserving study as at 31 December 2013.

7.30 The analysis used by external actuaries for each segment followed a common pattern insomuch that a number of generally accepted actuarial methods were used to produce point estimates of unpaid loss and ALAE reserves, gross and net[28] of reinsurance, based on data as at 31 December 2013. Where the claim development data had been distorted, e.g. by the significant changes in claims handling for Personal MTPL segment, combined with other market issues, the external actuaries factored into their analysis a number of key assumptions regarding future claims development and performance changes to mitigate such distortions.

7.31 The selected point estimates for each segment were chosen judgementally to reflect the range of results produced by the different methods and the strengths and weaknesses of each method.

7.32 The unpaid loss and ALAE reserves developed by the external actuaries are point estimates intended to represent the mean of the loss costs. The external actuaries' selected point estimates are stated to be central estimates, in the sense that they are not deliberately biased upwards or downwards. I interpret the central estimates to be on a basis greater than a 50% confidence level (as the claim distribution is expected to be positively skewed).

7.33 As at 31 December 2013, the external actuaries (commissioned by RSAIG) estimated a reserve deficit (gross of reinsurance) against the actuarial indication for the Italian branches of SIO and RSAI on total unpaid loss and ALAE reserves. Nonetheless, the deficit was more than offset by the management margin in the MBE reserves for total unpaid loss and ALAE reserves (gross of reinsurance) booked by the Italian branches of SIO and RSAI. Further, as outlined in paragraph 7.25 above, the overall claim development on the liabilities reviewed by the external actuaries has been favourable over the 12 months to 31 December 2014 as measured relative to the internal actuarial indication.

Conclusion

7.34 ***Overall, based on my review as described above as at 31 December 2014 (and 31 December 2013), the reserves of the Italian branches of SIO an RSAI appear reasonable at present.***

RESERVE STRENGH OF ITAS (PRE AND POST SCHEME)

7.35 As at 31 December 2014 ITAS held a provision for outstanding claims of €490.8m, of which €50.0m was for claims incurred but not reported. In addition, ITAS held a provision for unearned premiums of €177.7m.

7.36 The largest component of ITAS's claims provision is in respect of motor third party liability ("MTPL") business, which accounted for €231.0m, or 47%, of the outstanding claims reserves. The next largest line of business was general liability ("GL") which accounted for €157.0m, or 33%, of the outstanding claims reserves. These two lines together therefore accounted for 80% of outstanding provisions as at 31 December 2014.

7.37 Under Italian GAAP, ITAS must hold claims reserves at least sufficient to meet the undiscounted value of outstanding claims, including claims incurred but not reported, allocated loss adjustment expenses and unallocated loss adjustment expenses.

7.38 The claims department is responsible for establishing individual case estimates for each claim. A thorough review of all claims is carried out twice a year, in June and December. The actuarial department is responsible for a second phase review of claim reserves through the application of actuarial and statistical techniques.

[28] Only gross of reinsurance amounts were developed for SIO.

7.39 Reserves for the MTPL and GL lines are assessed by the actuarial department by means of standard actuarial techniques, in particular the chain-ladder and Bornhuetter-Ferguson methods, using both paid and incurred data. Where the results of the actuarial methods are greater than the case reserves, the additional amount is allocated, pro-rata to the individual claims by Accident Year.

7.40 For the other, substantially short tailed, lines of business, the case estimates established have historically proved to be conservative and this has led to a positive run-off. Typically, at the year-end, the run-off surplus is held back as a margin and added to individual claims on a proportionate basis. Actuarial models are not used for these lines, but key performance indicators (including run-off results, settlement speed, etc.) are monitored on a monthly basis.

7.41 An analysis of the claims run-off of the 4 largest lines of business over each of the last 3 years shows that each line of business has experienced a positive run-off in each year.

7.42 The claims reserving of ITAS is subject to two external actuarial reviews: by the Appointed Actuary (in respect of the MTPL class only) and the Auditing Actuary (for all classes).

7.43 I have been provided with a copy of the Appointed Actuary's report as at 31 December 2014. This report showed that ITAS's booked claims reserves for MTPL exceeded the Appointed Actuary's corresponding estimates, and he was able to confirm the adequacy of reserves held to cover future obligations under the contracts written.

7.44 I have also been provided with a copy of the Auditing Actuary's report as at 31 December 2014. In this report as at 31 December 2014, the Auditing Actuary detailed his own estimate of a range of reserves for the main reserving classes (being MTPL and GL). This showed that the booked reserves for both lines exceeded the Auditing Actuary's own selected reserve, which itself was selected to be greater than a best estimate.

7.45 ***I am satisfied that ITAS's held claims reserves as at 31 December 2014 are reasonable, and are at a level exceeding a best estimate.***

7.46 In accordance with the requirements of the Solvency II Directive, which is due to come into effect on 1 January 2016 (i.e. at the same time as the Effective Date), ITAS will need to set its Technical Provisions on a best estimate basis for regulatory purposes. ITAS will therefore need to make a number of changes to its approach to reserving. In particular, it will need to remove margins for prudence in its existing reserves so that they are on a best estimate basis. It will also need to discount its reserves for the time value of money. It will separately need to calculate a risk margin which will be added to the best estimate and will form part of the overall technical provisions. ITAS has made preparations for establishing its reserves on a Solvency II basis, and is well placed to adopt a revised approach to reserving once Solvency II comes into effect (ITAS's preparations for Solvency II are discussed in Section 10).

7.47 If the proposed Scheme is sanctioned, the Transferring Business will need to be incorporated into ITAS's reserving approach. As per the existing ITAS business, reserves for the Transferring Business will need to be established on a best estimate basis, in accordance with Solvency II. Whilst there do not appear to be significant margins for prudence in the reserves established by RSAI for the Transferring Business under UK GAAP, ITAS will need to make its own assessment of reserve requirements and will need to ensure compliance with Solvency II, for example by discounting for the time value of money.

7.48 ***As all of ITAS's reserves will need to be set on a best estimate basis, in accordance with the regulatory requirements of Solvency II, I do not believe that the reserve strength of ITAS will be materially affected by the Scheme.***

EXCESS ASSETS

7.49 For the purposes of my comparative analysis of the excess assets/capital levels of RSAI, SIO and ITAS pre and post the proposed Scheme, I have considered the extent to which each company holds capital in excess of its regulatory solvency level, in which case the actual capital that the company under consideration holds (the "Available Capital") will be greater than the "Required Capital" calculated. I refer to the ratio of Available Capital to Required Capital as the "Capital Cover Ratio". For the purposes of the terms I use in this Report, a company with sufficient capital (relative to the regulatory capital requirement under consideration) will have a Capital Cover Ratio just greater than 100%. I describe a company as well-capitalised if it has a Capital Cover Ratio greater than 150% (or thereabouts) and very well-capitalised if it has a Capital Cover Ratio in excess of 200% (or thereabouts).

7.50 If the Capital Cover Ratio increases after the Scheme for a group of policyholders, then there is an increase in security for those policyholders. If the Capital Cover Ratio reduces then there is a reduction in security and I need to consider whether the reduction is likely to be material to those policyholders.

7.51 RSAI, SIO and ITAS are all currently required to satisfy EU minimum capital requirements, also known as Solvency I (while noting that RSAI generally must also currently meet the capital requirements of the risk-based ICAS regime in the UK). However, Solvency II (a new EU-wide risk-based capital regime that will replace Solvency I and, for UK insurers, ICAS as well) will be implemented with effect from 1 January 2016. Given the coincidence of the Effective Date of the proposed Scheme and the implementation of Solvency II, I have made my assessment of the excess assets/available capital for the companies involved on both Solvency I and Solvency II bases.

7.52 I have used the Required Capital produced by the MCR (Solvency I) and the SCR (Solvency II) in order to calculate the Capital Cover Ratios, pre- and post-Scheme for different groups of policyholders (i.e. for the policyholders of RSAI and SIO that will transfer under the Scheme, and for the non-transferring policyholders of both RSAI and ITAS). For each group of policyholders this enabled me to understand not just their level of security if the Scheme is approved, but additionally how this compares against the level of security if the Scheme is not approved.

7.53 I comment further on these levels of security in the paragraphs below. I discuss the Capital Cover Ratios in qualitative (and where appropriate quantitative) terms that I believe to be appropriate to explain the implications for policyholder security.

EXCESS ASSETS OF RSAI

7.54 RSAI is a major UK insurer, and at the time of writing this Report has a Standard and Poor's rating of 'A' (stable outlook) and Moody's rating of A2 (negative outlook).

7.55 As at 31 December 2014 the policyholders of RSAI enjoyed the security of capital resources (i.e. assets available to meet regulatory capital requirements) as measured in RSAI's 2014 (consolidated) PRA return of £3,278 million compared with a statutory minimum capital requirement of £1,452 million. The Capital Cover Ratio for the MCR was therefore 226% and the free assets equal to £1,826 million (i.e. capital resources less MCR). RSAI could therefore be considered to be very well-capitalised as at 31 December 2014 (on a Solvency I basis).

7.56 RSAI is the largest insurer in RSAIG. RSAIG also has significant operations overseas, particularly in Scandinavia and Canada (which are owned through subsidiaries of RSAI). Thus RSAI is exposed to the financial destinies of these overseas operations. I understand that RSAIG's material operations comprise RSAI and its insurance subsidiaries. Thus the capital strength of RSAI also needs to be gauged by comparing the overall capital of RSAIG to the risks being run by RSAIG.

7.57 RSAIG has undertaken an analysis of the amount and quality of its capital and its adequacy both as at 31 December 2013 and over the period of the RSAIG 2014 – 2016 operational plan. The capital assessments were undertaken on a number of bases, including an ICA in line with current UK regulatory requirements, and Solvency II evaluations on internal model and standard formula bases, and these are documented in RSAIG's 2014 Capital Report (the latest such report available at the time of writing this Report, although, as discussed in paragraph 7.65 below, I have been provided with a draft of RSAIG's 2015 Group Capital Report, based on data as at 31 December 2014).

7.58 The ICA is a complicated process that relies on an assessment of the risks in the business, extensive modelling and management judgement to determine an appropriate figure. I have reviewed RSAIG's 2014 Capital Report, which details its ICA as at 31 December 2013. It describes the work conducted in order to make the assessment, including a discussion of the risks to which RSAIG/RSAI is subject in the course of its business.

7.59 RSAIG is exposed to a wide range of risks as described in paragraphs 3.25 to 3.34 above. The ICA identifies the following categories of risk:

- market risk (including currency risk);
- credit risk;
- insurance risk (including the risks associated with underwriting, reserving and catastrophes);

- operational risk (including acts of terrorism and failure of controls); and
- pension scheme risk.

7.60 In my review of the ICA/ICG and SCR, I have looked at the methodology underlying the calculations performed by RSAIG/RSAI in producing its ICA/ICG and SCR, and I have reviewed the key assumptions used in the model. In addition, I have discussed the ICA/ICG and Solvency II evaluations with the relevant internal actuaries in order to augment my review of the RSAIG's 2014 Capital Report (and update documents). Based on what I have reviewed, and my discussions with the relevant internal actuaries, I consider the methodology and modelling techniques used by RSAIG to be in line with current market practice and reasonable. The results of RSAIG's ICA/ICG show that it was sufficiently capitalised as at 31 December 2013 (pre the rights issue that was undertaken in 2014). My judgement is that the results provided appear reasonable, but I recognise that other results could have been generated using different sets of assumptions that are within the bounds of reasonableness.

7.61 As mentioned in paragraph 7.57 above, RSAIG's 2014 Capital Report also details its SCR under Solvency II. RSAIG intends to use an internal model to assess its capital requirements under Solvency II and the 2014 Capital Report shows the results of the calculation on this basis. Based on the modelling undertaken as at 31 December 2013, RSAIG could be considered to be sufficiently capitalised relative to its Solvency II capital requirements.

7.62 The modelling used by RSAIG for its ICA and its SCR calculation is essentially the same insomuch that the same parameterisation is used. The key differences are:

- the timeframe – the ICA uses a 1 year of trading (new/renewed business) horizon followed by modelling the run-off of the liabilities; whereas the SCR is based on the change in net assets over a one year trading time horizon;
- balance sheets after one year differ because, for example, the emergence of reserve risk is accelerated under the SCR compared to the ICA; and
- pension scheme risk is assessed on different bases, i.e. the ICA uses a funding basis, whereas the SCR uses an IAS19[29] basis.

7.63 As part of the capital modelling process, and detailed in the 2014 Capital Report, RSAIG has carried out a series of considered stress and scenario tests to assess its ability to withstand a range of different adverse outcomes. The 2014 Capital Report details six different stress tests, and four different scenario tests (the scenario tests being a combination of two of the stress tests). The stress situations were: a 1 in 20 year catastrophe event; a spike in UK motor claims inflation; a failure to deliver planned earnings; a market shock (20% fall in equities and 1% movement in interest rates); failure of its largest reinsurance counterparty; and a 20% weakening of sterling against key currencies. The likelihood of each stress situation and scenario was estimated. The likelihoods of the stress tests range from less than 1 in 5 to greater than 1 in 100 (this being the failure of the largest reinsurer). The likelihood of the scenarios tests range from 1 in 30 to "very remote". RSAIG has assessed the financial impact of each stress and scenario, and has expressed this as a percentage of its capital requirements. The scenario with the most significant impact on RSAIG was the combination of the 1 in 20 year catastrophe event with the market shock. The cost of this scenario was assessed as being equivalent to 19% of RSAIG's ICA/ICG capital requirement or 25% of its internal model SCR.

7.64 The 2014 Capital Report also sets out a series of tests that RSAIG has carried out to determine the sensitivity of its capital assessments to changes in the model assumptions. Some of the key sensitivities to RSAIG's ICA/ICG are noted as being the mean loss ratio (an adverse movement of 5% would increase the ICA/ICG by more than 18%), exposure to catastrophes (a 20% increase in frequency/severity would increase the ICA/ICG by over 12%) and the diversification assumption (a 20% reduction in diversification would increase the ICA/ICG by more than 11%).

[29] IAS 19 Employee Benefits (amended 2011) outlines the accounting requirements for employee benefits, including short-term benefits (e.g. wages and salaries, annual leave), post-employment benefits such as retirement benefits, other long-term benefits (e.g. long service leave) and termination benefits. The standard establishes the principle that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable, and outlines how each category of employee benefits are measured, providing detailed guidance in particular about post-employment benefits.

7.65 RSAIG's 2014 Capital Report includes a section on prospective capital positions, including those forecast on an ICA/ICG basis and on a Solvency II basis both as at 31 December 2014 (and 2015). The results as at 31 December 2014 (and 2015) take account of a rights issue and other measures undertaken by RSAIG since the 2013 year-end to strengthen its balance sheet. They show an increase in the forecast surplus capital relative to the position as at 31 December 2013, and an increased margin of available capital over the ICA/ICG and SCR, such that RSAIG could be considered to be more than sufficiently capitalised based on the projected Solvency II SCR positions as at 31 December 2014 (and 2015). I have also been provided with a copy of RSAIG's 2015 IMAP Capital Report (based on its financial position as at 31 December 2014). This likewise indicates that RSAIG could be considered to be more than sufficiently capitalised relative to ICA/ICG and Solvency II internal model SCR capital requirements.

7.66 Table 7.1 below summarises the financial position of RSAI (in terms of technical provisions and capital relative to the various capital requirements) as at 31 December 2014.

Table 7.1
Summary of the financial position of RSAI as at 31 December 2014

£m	RSAI
Technical Provisions	
Gross	7,338
Net	6,016
Minimum Capital Requirement	1,452
Available Capital	3,278
Capital Cover Ratio	226%
Description	Very Well Capitalised
Other capital measures	
ECR	Very Well Capitalised
ICA/ICG	> Sufficiently Capitalised
Solvency II Internal Model	> Sufficiently Capitalised

Notes
1. Technical provisions are based on the stand-alone accounts of RSAI and SIO.
2. MCR and ECR figures are calculated on a UK-entity consolidated basis.
3. ICA and Solvency II capital descriptions are based on RSA Group results.

7.67 My review of RSAIG's 2014 Capital Report (and draft 2015 Capital Report) has given me no cause to doubt the reasonableness of the ICA/ICG and Solvency II capital positions as at 31 December 2014 (and 2015), and the key uncertainties in those projections. Nonetheless, I intend to review them in more detail on receipt of RSAIG's finalised 2015 Capital Report and report on the findings of my review in my Supplementary Report to the Court (see paragraph 1.30 above).

Conclusion

7.68 ***Overall, based on my review as described above concerning the excess assets of RSAI as at 31 December 2014 (and as at 31 December 2013), I believe the policyholders of RSAI, including those who will transfer under the proposed Scheme, currently benefit from the strength provided by a more than sufficiently capitalised company.***

EXCESS ASSETS OF SIO

7.69 As at 31 December 2014 the policyholders of SIO enjoyed the security of capital resources (i.e. available capital available to meet regulatory capital requirements) as shown in RSAI's consolidated 2014 PRA return of £59.9 million compared with a statutory minimum capital requirement of £23.5 million. The Capital Cover Ratio for the MCR was therefore 255% and the free assets equal to £36.4 million (i.e. capital resources less MCR). SIO could be considered to be very well-capitalised as at 31 December 2014 (on a Solvency I basis). SIO's financial position is summarised in Table 7.2 below.

Table 7.2
Summary of the financial position of SIO as at 31 December 2014

£m	SIO
Technical Provisions	
Gross	354
Net	0
Minimum Capital Requirement	23.5
Available Capital	59.9
Capital Cover Ratio	255%
Description	Very Well Capitalised

7.70 As outlined in paragraph 3.54 above, SIO has entered into intra-group reinsurance arrangements with RSAI that cover the entirety of SIO's gross insurance liabilities net of collected inuring reinsurance, both past and future. Therefore, notwithstanding paragraph 7.69 above, SIO's financial strength is substantially provided by RSAI.

7.71 ***Based on my review as described above concerning the financial strength of SIO as at 31 December 2014 (and as at 31 December 2013), I believe the policyholders of SIO, including those who will transfer under the proposed Scheme, currently benefit from the strength provided by a more than sufficiently capitalised company.***

EXCESS ASSETS OF ITAS

7.72 As at 31 December 2014 the policyholders of ITAS enjoyed the security of capital resources (i.e. assets available to meet regulatory capital requirements) as measured in ITAS's regulatory return to IVASS of €278.6 million compared with a statutory MCR of €74.9 million. The Capital Cover Ratio on a Solvency I basis was 372%, i.e. ITAS was very well-capitalised on a Solvency I basis.

7.73 ITAS is required to maintain capital at least equal to its required MCR at all times up to and including 31 December 2015, after which the new Solvency II regime becomes effective. ITAS has therefore also undertaken Solvency II evaluations of the company's and the group's respective SCRs as at 31 December 2014 on the standard formula basis. At the time of writing this Report, a report detailing the work carried out to produce the SCR was not available. However, ITAS has provided me with the results of its SCR calculations.

7.74 I have performed a review of the standard formula analysis produced by ITAS both at a solo (i.e. company) and group level. Discussions on the methodology and assumptions used in the SCR calculations have been undertaken with relevant members of the internal risk and finance teams in order to ensure my understanding of the analyses conducted and I have received satisfactory answers to these questions.

7.75 The key components of ITAS's solo SCR (prior to any allowance for loss absorbency) as at 31 December 2014 were as follows:

- Non-life and Health underwriting risk arising from the adverse development on claim and premium reserves, inadequate premiums on future business and catastrophe losses contributed approximately 60% to the overall undiversified SCR;
- Market risk accounts for another 30% of the undiversified SCR, with each of interest, equity, property and spread making some contribution;
- Counterparty risk arising primarily from risk mitigation for ceded natural catastrophe exposures (which is required due to the calibration of the Catastrophe module on a net of reinsurance basis), the default risk on bank deposits and to a lesser extent other reinsurance contracts. Counterparty risk contributed 6% to the overall undiversified SCR; and
- Operational risk arising from inadequate or failed internal processes, people, systems or external events, which contributed a 4% to the overall undiversified SCR (based on the simple formulaic approach used in the standard formula);

7.76 The Solvency II standard formula calculation as at 31 December 2014 produced results for Available Capital (Own Funds in Solvency II terminology) and Required Capital (i.e. SCR) to give a Capital Cover Ratio that indicated that ITAS would have been a very well-capitalised company on a Solvency II basis.

7.77 My analysis above describes the excess assets of ITAS in the pre-Scheme situation as at 31 December 2014. I also need to consider the excess assets of ITAS post-Scheme.

7.78 As the Scheme will result in no surplus assets being added to ITAS's balance sheet on the Effective Date (i.e. the assets transferred are equal in value to that of the liabilities transferred) the Available Capital to meet (regulatory) Required Capital will, all other things being equal, remain unchanged. However, because the volume of premiums and Technical Provisions assumed by ITAS as a result of the Scheme has increased the (regulatory) Required Capital will increase, simply because more risk has been accepted. Therefore, all other things being equal, the Capital Cover Ratios on both Solvency I and Solvency II bases will decrease, potentially materially impacting the financial security presently enjoyed by the policyholders of the Transferring Business and also the existing policyholders of ITAS.

7.79 The senior management of ITAS are aware that, in the absence of any management actions, the Scheme will reduce the company's excess assets. The company has therefore put in place a Management Action Plan (the "MAP") to:

(1) raise €60m of subordinated debt, thereby explicitly increasing Available Capital; and to

(2) de-risk the balance sheet by purchasing additional reinsurance (i.e. to replace/enhance the reinsurance protecting the Transferring Business previously provided through RSAIG and increasing the level of Catastrophe cover) thereby reducing the Required Capital under Solvency II.

7.80 With regard to item (1) in paragraph 7.79 above, on 19 March 2015 the Board of ITAS approved the issue of a subordinated bond for a nominal amount of €60m. Following ITAS's auditor's favourable opinion on the issue of the bond, on 17 April 2015 ITAS applied to IVASS for the bond to be eligible as tier 2 capital under Solvency II. IVASS has acknowledged the application and is expected to give its opinion within 60 days of receipt of the application. The loan will be offered to professional investors and listed on the Irish stock market. The launch of the bond offering is expected to take place by end-June 2015, and the loan is expected to be paid by mid-July 2015.

7.81 I am satisfied that ITAS is making appropriate progress in raising this additional capital such that it should be in place prior to the court hearing at which the sanctioning of the Scheme will be considered. I will report further in my Supplementary Report on the status of the issuing of the subordinated loan. I take reassurance from the ITAS Board Resolution, a translated copy of which I have read, as the undertaking to raise €60m of subordinated debt cannot be disregarded without proper consideration by the ITAS Board. In addition, I expect any proposed changes to, or deviations from, the Board resolution in the future would be of interest to IVASS and the PRA/FCA as appropriate.

7.82 With regard to item (2) in paragraph 7.79 above, ITAS has entered into discussions with a number of reinsurers to develop a suitable reinsurance programme to de-risk the balance sheet, in particular the inclusion of a greater level of CAT cover (for earthquake risk).

7.83 I have been copied-in on and have received a Memorandum of Intent from ITAS, signed by Mr Ermanno Grassi (Director General), that instructs the company's reinsurance department to:

- ensure an equivalent level of reinsurance cover to that presently covering the Italian branch of RSAI is in-force by the Effective Date;
- extend the level of Catastrophe cover by €100m by the Effective Date;
- assist in establishing a Solvency II Cover Ratio for the policyholders of the Transferring Business at least comparable with the level before of the Scheme, and that the current policyholders/members of ITAS enjoy a Solvency II Cover Ratio at an adequate level post-Scheme.

7.84 At the date of this Report, ITAS had received written proposals from five major reinsurers to provide the additional cover and the contracts are expected to be formally signed by the end of July 2015, with the additional cover to come into effect on 1 January 2016.

7.85 I take comfort from the Memorandum of Intent as the revised reinsurance programme is to be formalised by the Board of ITAS via an appropriate Board resolution. In this manner the undertaking to acquire additional reinsurance consistent with ITAS's Memorandum of Intent cannot be disregarded without any proper consideration by the ITAS Board. In addition, I expect any proposed changes to, or deviations from, the Board resolution in the future would be of interest to IVASS and the PRA/FCA as appropriate.

7.86 Had the Scheme been implemented as at 31 December 2014, together with the MAP described in paragraph 7.79 above, the policyholders of ITAS (including the policyholders of the Transferring Business) would (on a pro-forma Solvency I basis) have enjoyed the security of capital resources (i.e. assets available to meet regulatory capital requirements) of approximately €277.5 million compared with a MCR of €105.5 million. The Capital Cover Ratio on a Solvency I basis would have been circa 263%, i.e. ITAS post-Scheme would continue to be a very well-capitalised company on a Solvency I basis.

7.87 At a high level, these figures indicate that ITAS pre-Scheme is very well-capitalised relative to its Solvency I position. If the Scheme was implemented as at 31 December 2014, the policyholders of the Transferring Business would enjoy a pro-forma Solvency I cover ratio of 2.6 compared to 2.6 (in the case of the SIO policies) or 2.3 (in the case of the RSAI policyholders) pre-Scheme (see paragraphs 7.55 and 7.69 above). Therefore, the Capital Cover Ratio for the policyholders of the Transferring Business increases and thus there is an increase in security on a Solvency I basis.

7.88 Similarly, had the Scheme been implemented as at 31 December 2014, together with the MAP described in paragraph 7.79 above, the results of the Solvency II standard formula calculations performed by ITAS show that the policyholders of ITAS (including the policyholders of the Transferring Business) would have enjoyed the security of a well-capitalised company on a Solvency II basis as at that date. The financial position of ITAS, both pre- and post-transfer is summarised in Table 7.3 below.

Table 7.3
Summary of the financial position of ITAS pre- and post-transfer, as at 31 December 2014

€m	ITAS Mutua	
	Pre-Transfer	Post-Transfer
Technical Provisions		
Gross	669	1,168
Net	638	1,100
Minimum Capital Requirement	75	106
Available Capital	279	278
Capital Cover Ratio	372%	263%
Description	Very Well Capitalised	Very Well Capitalised
Solvency II Standard Formula	Very Well Capitalised	Well Capitalised

7.89 The key components of ITAS's SCR post-Scheme (as per paragraph 7.88 above) as a proportion of the overall undiversified SCR would have been approximately: non-life and health underwriting risk 60%; market risk 24%; counterparty risk 10%; and operational risk 6%.

7.90 Had the Scheme been implemented as at 31 December 2014 (together with the successful implementation of the MAP), the policyholders of the Transferring Business would have enjoyed a pro-forma Solvency II Cover Ratio of a well-capitalised company compared to that of a more than sufficiently capitalised company anticipated pre-Scheme (see paragraph 7.65 above). Therefore, the Capital Cover Ratio for the policyholders of the Transferring Business is anticipated to increase and thus there is an anticipated increase in security on a Solvency II basis. If the MAP were not implemented, post-Scheme ITAS would be more than sufficiently capitalised based on its projected Solvency II Capital Cover Ratio using data as at 31 December 2014. This Capital Cover Ratio would be slightly less than that enjoyed by the policyholders of the Transferring Business pre-Scheme. Whilst the extent of the reduction in the Capital Cover Ratio for the policyholders of the Transferring Business may not be material (I discuss what I mean by "material" in Section 6 above), the non-implementation of the MAP would lead to be a significant decrease in the Capital Cover Ratio of ITAS, and hence the management of ITAS believes it is necessary to carry out the MAP to ensure acceptable levels of capital in ITAS.

7.91 ITAS has performed a number of stress and scenario tests to assess its ability to withstand a range of different adverse outcomes after the implementation of the Scheme. ITAS estimated the effect of the stress on both the company's own funds and SCR. The stress tests investigated were: a catastrophe event; the default of a major reinsurer; a step increase in inflation to 8%; a 50% increase in the operation risk charge in the standard formula calculation; a 10% increase in reserves across all lines of business; and an increase in the shock for property risk in the standard formula (from 25% to 35%). ITAS also considered three scenario tests, being the combination of two of the individual stresses. The most severe scenario tested was a combination of the catastrophe event with the inflation shock. All of the scenarios considered led to a considerable reduction in the solvency of ITAS, but in all cases ITAS's own funds relative to its SCR were sufficient to ensure that it could still be considered more than sufficiently capitalised.

7.92 My analysis above of the excess assets of ITAS has been made at the individual entity (solo) level. However, as described in Section 4 above, ITAS is the leader (holding entity) of the ITAS Group, which operates in the life and non-life market. ITAS is therefore exposed to the financial destinies of these life and non-life operations. Thus, while the subsidiary holdings of ITAS are included as participations (and stressed accordingly) in the solo standard formula calculation for ITAS, I also need to consider the capital strength of ITAS by comparing the overall capital of the ITAS Group to the risks being run by the ITAS Group.

7.93 After ITAS, the most significant subsidiary in the ITAS Group is ITAS Vita, a life insurance company that is 65% owned by ITAS (see paragraphs 4.27, 4.28 and 4.29 above). Therefore before considering the overall capital of the ITAS Group to the risks being run by the ITAS Group, I have first considered the Available Capital (eligible Own Funds) of ITAS Vita relative to the risks being run by the ITAS Vita.

7.94 ITAS Vita has provided me with the results of its SCR calculations on a solo standard formula basis as at 31 December 2014, and I have performed a review of the standard formula analysis produced by ITAS Vita. As with my review of the ITAS standard formula calculations (see paragraph 7.74 above) discussions on the methodology and assumptions used in the SCR calculations have been undertaken with relevant members of the internal risk and finance teams in order to ensure my understanding of the analyses conducted and I have received satisfactory answers to these questions.

7.95 The key components of ITAS Vita's SCR as at 31 December 2014 as a proportion of the overall undiversified SCR, before adjustments for loss absorbency, were approximately: Life underwriting risk 30%; Market risk 49%; Counterparty risk 8%; and Operational risk 13%. Furthermore, the standard formula calculations for ITAS Vita produced a Capital Cover Ratio that indicated that the company was well-capitalised on a Solvency II basis as at 31 December 2014.

7.96 Turning to the overall ITAS Group capital position as at 31 December 2014, ITAS has also performed group standard formula calculations as at 31 December 2014, both on a pre-Scheme basis, and on the assumption that the Scheme and the MAP had both been implemented. The key components of ITAS Group's SCR post-Scheme as at 31 December 2014 as a proportion of the overall undiversified SCR, before adjustments for loss absorbency, were approximately: Non-life and health underwriting risk 48%; Life underwriting risk 8%; Market risk 26%; Counterparty risk 11%; and Operational risk 7%.

7.97 The calculations produced a Capital Cover Ratio that indicated that the ITAS Group (prior to implementation of the Scheme) was well-capitalised on a Solvency II basis (albeit at a reduced level to that of the solo entity). Had the Scheme and MAP been implemented as at 31 December 2014, the calculations produced results that indicated that the ITAS Group (including the Transferring Business) could also be considered to be a well-capitalised company on a Solvency II basis, albeit at a reduced level to that of the ITAS Group (pre-Scheme). I do not consider the reduction in security to be material to the policyholders of the Transferring Business particularly as the financial security of the ITAS Group (post-Scheme) as measured using Capital Cover Ratios is forecast to be no less than that of RSAIG pre-Scheme (see paragraph 7.65 above).

7.98 ITAS has assessed the impact of the stress and scenario tests described in paragraph 7.91 above on ITAS Group as well as ITAS as an individual entity. The effect of the stresses on the Group was similar to ITAS as an individual entity, albeit slightly less pronounced. The scenarios in all cases left the Group being more than sufficiently capitalised. The financial position of the ITAS group (both pre-Scheme and post-Scheme) is summarised in Table 7.4 below.

Table 7.4
Summary of the financial position of ITAS Group pre- and post-transfer, as at 31 December 2014

€m	ITAS Group	
	Pre-Transfer	Post-Transfer
Technical Provisions		
Gross	2,129	2,628
Net	2,080	2,542
Minimum Capital Requirement	153	179
Available Capital	269	272
Capital Cover Ratio	176%	152%
Description	Well Capitalised	Well Capitalised
Solvency II Standard Formula	Well Capitalised	Well Capitalised

7.99 I will comment further, as necessary, on the solvency positions of ITAS, and report on this matter as part of my supplementary/update report (see paragraph 1.30 above).

Conclusion

7.100 ***Based on my review of the excess assets of ITAS as at 31 December 2014, as described above, I believe that ITAS is a well-capitalised company and will continue to be so if the Scheme is sanctioned (subject to the successful implementation of the MAP).***

Relative Financial Strength of Transferring Policyholders pre- and post-Scheme

7.101 I have concluded above, based on my review of excess assets held relative to Solvency I and Solvency II capital requirements, that RSAI was, as at 31 December 2014, a more than sufficiently capitalised company, and that ITAS was a well-capitalised company (both pre- and post-Scheme). Therefore ITAS had, on the measures considered, a greater degree of excess assets relative to its capital requirements (both pre- and post-Scheme). This would suggest that, in terms of excess assets and the security that they afford policyholders, the policyholders of the Transferring Business would likely benefit from the Scheme being sanctioned. I note that RSAIG has calculated its Solvency II SCR using an internal model, whereas ITAS has used the standard formula method. Whilst these methods are different, they both target the same confidence level (i.e. 99.5% likelihood of maintaining solvency over a 1 year time horizon), they are both valid approaches under the Solvency II framework and they are expected to be the approaches that RSAI and ITAS will use for calculating their respective SCRs when Solvency II comes into effect on 1 January 2016. I therefore believe that it is reasonable to compare the solvency of the two companies using these measures. Notwithstanding this, I do note that ITAS could potentially benefit from a lower capital requirement were it to develop an internal model which is more closely tailored to the particular risks to which its business is exposed, unlike the generic standard formula. If that what the case, this would only bolster the conclusion that, in terms of comparative capital cover ratios, the policyholders of the Transferring Business would benefit from the Scheme being sanctioned.

7.102 It should be borne in mind, that while the excess assets in RSAI are, in relative terms, less than those in ITAS, in absolute terms the amount of excess assets is far greater in RSAI, and policyholders of RSAI do benefit from being part of a larger and more diversified insurance company, compared to ITAS.

7.103 Pre-Scheme, were RSAI to become insolvent, the policyholders of the Transferring Business would continue to access the remaining assets of RSAI. However, the policyholders of SIO (the vast bulk of the policyholders of the Transferring Business) would rank behind the direct policyholders of RSAI, because their business is wholly reinsured by RSAI (see paragraph 3.53 above).

7.104 Pre-Scheme, were ITAS to become insolvent, the policyholders of the Transferring Business would continue to have their claims paid by RSAI. Post-Scheme, were ITAS to become insolvent, the policyholders of the Transferring Business would not have any recourse to RSAI. Nonetheless, in accessing the remaining assets of ITAS earmarked to cover the Technical Provisions in the event of its insolvency, the policyholders of the Transferring Business would rank alongside the policyholders of ITAS. This would appear to be a potential advantage of the Scheme from the point of view of the policyholders of SIO within the Transferring Business. However, given the reserve strength and the level of excess assets within each company, the insolvency of either ITAS or RSAI would presently appear to be a remote possibility, and one that would not be materially affected by the Scheme.

7.105 As stated in paragraph 5.19 above, ITAS does not participate in the FSCS. Nonetheless, the impact on eligible policyholders of the Transferring Business is unlikely to be significant for a number of reasons, including:

- As identified in paragraph 7.104 above, the winding-up scenario is presently remote. As such a call on the statutory fund of the FSCS is likewise presently remote;
- The National Guarantee Fund for Road Accident Victims in Italy provides some of the cover of the FSCS (in that it provides for compensation to victims of road traffic accidents where the vehicle is insured with an insurer that has been placed under compulsory winding up at the time of the accident);
- The ongoing oversight of IVASS, especially moving into the even more transparent Solvency II regime, is important in ensuring that ITAS is able to cover its obligations.

7.106 ***I am therefore satisfied that the policyholders of the Transferring Business will not be materially adversely affected due to relative differences in the financial strength of ITAS post-Scheme to those of RSAI pre-Scheme.***

Changes in Risk Exposures

7.107 If the Scheme is sanctioned, the policyholders of the Transferring Business will no longer be exposed to the risk exposures of RSAI, but will be exposed to those of ITAS.

7.108 There are significant differences between the risk exposures in ITAS relative to those in RSAI, in particular relating to the types of business written and geographical spread. ITAS is a medium-sized insurer writing personal and commercial lines business predominantly in Italy (as summarised in paragraph 4.13 above).

7.109 RSAI is a large and diverse insurance company writing business predominantly in the UK, but also in Belgium, France, Germany, Greece, Italy, the Netherlands and Spain (as summarised in paragraph 3.2 above). It also has large indirect exposures to business in Canada and Scandinavia (as outlined in paragraph 7.56 above). Furthermore, the liabilities of RSAI include a large and uncertain legacy portfolio, whose principal risks relate to UK asbestos exposures.

7.110 The policyholders of the Transferring Business will lose the benefit afforded by being part of a large and diverse insurance company. On the other hand, they will no longer be exposed to RSAI's large and uncertain legacy portfolio.

7.111 The Transferring Business is dominated by the Italian branch business of SIO, which is comprised largely of personal and commercial lines (as summarised in paragraph 3.58 above). The composition of the Italian branch business of SIO is in the main similar to that of ITAS, so the risks associated with the Transferring Business are presently largely understood by ITAS through the management of its existing portfolio.

7.112 The Transferring Business will also have an indirect exposure to the insurance subsidiaries of ITAS, and in particular to that of ITAS Vita. Based on my review of the capital position of ITAS Vita as at 31 December 2014 as summarised in paragraph 7.95 above, I am satisfied that had the Scheme been implemented as at 31 December 2014, the policyholders of the Transferring Business would not be materially adversely impacted by their indirect exposure to ITAS Vita (and that arising from the smaller non-life subsidiaries of ITAS).

7.113 Based on my analysis of changes in risk exposures as outlined above, the Scheme creates both potential positives and negatives for the policyholders of the Transferring Business. Nonetheless, given the financial strength of ITAS, as discussed above, I do not consider that the policyholders of the Transferring Business will be materially adversely affected by the changes in risk exposures.

Conclusion

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

Policy Servicing

7.115 There will be no change to the policy administration arrangements of the transferring Italian branch business of SIO as a result of the Scheme, insomuch that the current staff and the self-standing administration and IT platform of SIO (see paragraph 5.22 above) will transfer to ITAS under the BSTA. Whilst ITAS will consider converging the claims systems for the SIO and existing ITAS policies (those for the latter already being set-up to administer materially similar types of business), I am informed that this would not take place before late 2017 or 2018 (by which time a significant proportion of the Transferring Business would be expected to have run off) and would only occur if and when a robust transition could be guaranteed both for the existing ITAS policyholders and those of the Transferring Business. Therefore, the transferring policyholders of the Italian branch of SIO should experience little (if any) change to policy servicing standards resulting from the Scheme. ITAS believes, based on meetings between the companies, that there is broad alignment between it and the Italian branch businesses of RSAI and SIO in terms of claims handing approach, process and customer care, and that strict Italian regulations concerning claims handling have given rise to a consistent culture of claims handling across Italian insurance companies.

7.116 The policy administration arrangements for the transferring Italian branch business of RSAI will be impacted as a result of the Scheme, insomuch that the self-standing administration and IT platform will not transfer to ITAS under the BSTA.

7.117 The multinational business presently written through the Italian branch of RSAI (as a member of the (RSA) Global Network) is supported by two administration systems:

- IPGlobal – this system supports ATLAS (see below) in the first steps of the multinational process; the system is available for all the companies involved in (that are part of) the (RSA) Global Network and is used for quoting, claims management and data integration with company specific IT systems;
- ATLAS – the system that RSAI currently uses for underwriting, accounting and claims management processes relating to the management of policies, accounting and claims for multinational business. ATLAS is integrated with IPGlobal.

7.118 ITAS is presently in discussions with RSAI about becoming part of the (RSA) Global Network, and it is expected that ITAS will formally be accepted into the Global Network in July 2015. As such the IPGlobal system would be available to ITAS with effect from the date of commencement of membership, i.e. on or before the Effective Date.

7.119 Notwithstanding the expected outcome in paragraph 7.118 above, ITAS will still need to implement ATLAS (or a similar system) in order that they can continue to service effectively the transferring Italian branch business of RSAI. I understand that ITAS and RSAI have commenced a feasibility study for ITAS to acquire a clean version of ATLAS from RSAI. This would allow ITAS to achieve continuity of servicing the multinational business and to keep the current integration with IPGlobal. Furthermore, RSAI and ITAS have entered into a transitional agreement under which ITAS will continue to be able to use the ATLAS system for a period of 6 months after the Effective Date of the Scheme. This will ensure continuity of service during that period and give ITAS additional time to either agree the terms of acquiring ATLAS, or finding some suitable replacement. In the event that ATLAS is not acquired by ITAS or an alternative system not adopted by the end of the 6 month period, a further extension period would be negotiated between the parties, although this would, unlike the initial extension, be likely to require ITAS to pay fees to RSAI for the ongoing support. As a contingency measure, ITAS proposes a manual transfer of the policies and claims (which are relatively small in number) onto their existing system or to staff the operation adequately to facilitate a purely manual administering of the business.

7.120 I have discussed with RSAI and ITAS the proposed approach (including timing) to having satisfactory systems in place at ITAS to service the transferring Italian branch business of RSAI (as outlined above) and I am of the view that the policy servicing for the transferring policyholders of the Italian branch of RSAI should not be materially adversely affected as a result of the Scheme. Nonetheless, I will comment further in my supplementary/update report (see paragraph 1.30 above) on the whether ITAS is admitted as a member of the (RSA) Global Network and developments in the feasibility study being undertaken by ITAS and RSAI on providing a copy of the ATLAS system to ITAS.

7.121 The Transferring Business is currently subject to Italian conduct of business regulation, including consumer protection rules. IVASS oversees the compliance of the Transferring Business with the Italian insurance laws and regulations, implementing, inter alia, the relevant EU Directives. This will not change as a result of the Scheme.

7.122 As noted in paragraph 5.21 above, the policyholders of the Transferring Business currently have no rights of access to FOS and this will not change as a result of the Scheme. They will however continue to be able to bring complaints to IVASS following the implementation of the Scheme.

7.123 I note that the policyholders of the Transferring Business will not become members of ITAS as a result of the Scheme, but will become members of ITAS on the first renewal post-Scheme. If they choose not to renew they will never become members. Therefore, no membership rights will be conferred on the policyholders of the Transferring Business as a direct result of the Scheme.

7.124 I am informed by RSAI/SIO that the vast majority of the non-motor retail and commercial policies of the Transferring Business have a tacit renewal clause under which the current policy terms and conditions (including price) can renew automatically. If RSAI/SIO want to change any of the policy terms notice must be given to the customer (usually 30-90 days in advance). ITAS has confirmed to me that it will honour the tacit renewal clause in the policies if the Scheme is sanctioned. Therefore, ITAS will be obliged to renew any policies that are within the notice period on the Effective Date of the Scheme on the existing terms of the policy.

7.125 Motor business in Italy must be priced according to a tariff that is actuarially justified and reviewed by ITAS. Any change in the tariff must be published 60 days in advance of coming into effect. Premiums for renewing policies will be charged in accordance with the tariff in force at the renewal date. I have been informed by ITAS that, following the implementation of the Scheme it will apply a tariff in line with that used by RSAI/SIO. Any policyholders of the Transferring Business whose policies are up for renewal following the Effective Date of the Scheme can therefore expect it to be able to renew their policies for a premium in line with what would have been available had the Scheme not been implemented and, as is the case currently, no change can be made to the tariff without 60 days advance notice, such tariff having been approved by IVASS.

7.126 RSAI/SIO non-motor business with no tacit renewal clause is re-underwritten every year, and pricing and terms and conditions may therefore change. As such the renewal process for these policies of the Transferring Business will be unchanged post-Scheme.

Conclusion

7.127 ***I believe that the proposed Scheme is unlikely to have a materially adverse impact on the standards of policy servicing experienced by the policyholders of the Transferring Business compared to their current position, provided in the case of the transferring policyholders of the Italian branch of RSAI, that plans are finalised ahead of the Court hearing to sanction the Scheme to ensure that satisfactory systems will be in place at ITAS to service the multinational business from the Effective Date and thereafter.***

Conclusion for the Policyholders of RSAI and SIO transferring under the Scheme

7.128 ***I am satisfied that the proposed Scheme does not affect in a materially adverse way either the security or the policy servicing levels of the policyholders of SIO and RSAI transferring under the proposed Scheme.***

8. THE IMPACT OF THE SCHEME ON THE POLICYHOLDERS OF RSAI AND SIO WHO WILL REMAIN IN PLACE AFTER THE TRANSFER

8.1 If the Scheme is sanctioned the liabilities pertaining to the Transferring Business will be removed from the balance sheets of RSAI and SIO, along with suitable assets (including external reinsurance) of equivalent value at the Effective Date. No other assets will be transferred to ITAS.

8.2 RSAI's overall gross and net Technical Provisions will both reduce by approximately 6%, i.e. they will not be materially changed in value or composition as a result of the proposed Scheme.

8.3 RSAI's capital requirements on MCR, ICA and Solvency II bases will reduce as a result of the removal of these liabilities and related risks from RSAI's balance sheet under the proposed Scheme. As Available Capital will be unchanged, RSAI's solvency margin will improve. Table 8.1 below summarises the financial position of RSAI (in terms of technical provisions and capital relative to the various capital requirements) on both a pre- and post-transfer basis, as at 31 December 2014.

Table 8.1
Summary of the financial position of RSAI pre- and post-transfer, as at 31 December 2014

£m	RSAI	
	Pre-Transfer	Post-Transfer
Technical Provisions		
Gross	7,338	6,969
Net	6,016	5,658
Minimum Capital Requirement	1,452	
Available Capital	3,278	
Capital Cover Ratio	226%	
Description	Very Well Capitalised	Very Well Capitalised
Other capital measures		
ECR	Very Well Capitalised	Very Well Capitalised
ICA/ICG	> Sufficiently Capitalised	> Sufficiently Capitalised
Solvency II Internal Model	> Sufficiently Capitalised	> Sufficiently Capitalised

Notes
1. Technical provisions are based on the stand-alone accounts of RSAI and SIO.
2. MCR and ECR figures are calculated on a UK-entity consolidated basis.
3. ICA and Solvency II capital descriptions are based on RSA Group results.
4. Post-transfer, the solvency position is expected to be at least as strong as pre-transfer under all measures.

8.4 The remaining policyholders will also benefit from no longer having any exposure to the risks associated with the liabilities of the Transferring Business.

8.5 There will be no changes to the administration of the remaining RSAI business as a result of the Scheme.

Conclusions for the policyholders of RSAI not transferring under the Scheme

8.6 ***For the reasons discussed above, I am satisfied that the proposed Scheme will not have an adverse effect on the security of RSAI policyholders not transferring under the Scheme, and further, the service levels provided to these policyholders will not be affected by the proposed Scheme.***

8.7 If the Scheme is sanctioned as envisaged the liabilities pertaining to the entire insurance business of SIO will be transferred to ITAS and be removed from the balance sheet of SIO, along with appropriate assets of SIO of equivalent value. Accordingly, there is anticipated to be no remaining policyholders of SIO as a result of the proposed Scheme on the Effective Date. Table 8.2 below summarises the financial position of SIO, on both a pre- and post-transfer basis, as at 31 December 2014.

Table 8.2
Summary of the financial position of SIO pre- and post-transfer, as at 31 December 2014

£m	SIO	
	Pre-Transfer	Post-Transfer
Technical Provisions		
Gross	354	0
Net	0	0
Minimum Capital Requirement	23.5	N/A
Available Capital	59.9	0
Capital Cover Ratio	255%	N/A
Description	Very Well Capitalised	N/A

Notes
1. Following the transfer, SIO is not expected to have any remaining insurance liabilities and, if this is the case, will be deauthorised.

8.8 As described in paragraph 5.10 above, it is not currently expected that there will be any Excluded Policies. In the unlikely event of there being policies that would need to be Excluded Policies, I understand that SIO would discuss the situation with the Regulator before proceeding with the Scheme.

Conclusions for the Policyholders of SIO not transferring under the Scheme

8.9 ***As there is currently no expectation that there will be any Excluded Policies (and hence no remaining policyholders of SIO) as a result of the proposed Scheme on the Effective Date, I have not considered the matter further***.

9. THE IMPACT OF THE SCHEME ON THE CURRENT ITAS POLICYHOLDERS

Introduction

9.1 Under the Scheme, the policyholders of ITAS will remain in ITAS in the same position as prior to the Effective Date of the Scheme. The main effect of the Scheme on these ITAS policyholders arises from the transfer into ITAS of all the business currently in the Italian branches of RSAI and SIO.

9.2 The key issues affecting existing ITAS policyholders as a result of the Scheme arise from changes in:

- The financial strength of ITAS as a result of the transfer in of all the business currently in the Italian branches of RSAI and SIO;
- The risk exposures in ITAS;
- The policy servicing levels of the business of ITAS.

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

Financial Strength

9.4 In Section 7, I considered the current reserve strength and excess assets of ITAS (generally). Based on my reviews of the reserve strength and excess assets of ITAS (generally), I concluded that the policyholders enjoy the security of a well-capitalised company.

9.5 Had the proposed Scheme taken place as at 31 December 2014, the Transferring Business would have represented a material proportion of the Technical Provisions (gross of reinsurance) of ITAS (as at 31 December 2014 they totalled €500 million and represented circa 75% of ITAS's gross Technical Provisions of €668.5 million). Nonetheless, as outlined in paragraphs 7.45 and 7.48 above, I am satisfied that ITAS is currently reasonably reserved and should continue to be so after the implementation of the Scheme.

9.6 As described in Section 10, the Transferring Business will continue to benefit from the external reinsurance contracts associated with the business, which will to transfer to ITAS under the Scheme.

9.7 I also considered in Section 7 the excess assets of ITAS post-Scheme, from the perspective of the policyholders of the Transferring Business. I now consider the position of the ITAS policyholders remaining after the proposed Scheme. Had the proposed Scheme taken place as at 31 December 2014, the Solvency I Capital Cover Ratio would have been 2.6 compared to 3.7 pre-Scheme. Therefore, the current ITAS policyholders will experience a reduction in their Capital Cover Ratio and hence a reduction in security on a Solvency I basis. However, I do not consider the reduction in security to be material to the ITAS policyholders because the Capital Cover Ratio remains high at 2.6 and the free assets (i.e. capital resources less MCR) are significant at approximately €172 million.

9.8 I have also assessed the Solvency II Capital Cover Ratios for ITAS (both as a solo entity and as a group) pre-Scheme and post-Scheme on the assumption that the Scheme was implemented as at 31 December 2014 (and the MAP described in paragraph 7.79 above was successfully implemented). The post-Scheme Solvency II Capital Cover Ratios (for the solo entity and group) would have been less than the corresponding pre-Scheme ratios, so the current ITAS policyholders would have experienced a reduced level of security measured on a Solvency II basis post-Scheme. Nonetheless, they would have continued to be policyholders of a well-capitalised company. Tables 7.3 and 7.4 above summarise the financial positions of both ITAS and the ITAS Group, on both a pre- and post-transfer basis, as at 31 December 2014.

9.9 I note that if the MAP is not implemented, post-Scheme ITAS's Solvency II Capital Cover Ratio would reduce further, such that it could only be considered more than sufficiently capitalised. Whilst such a level of capitalisation would be more than adequate to meet its anticipated capital requirements under Solvency II calculated using the standard formula, it would represent a considerable reduction in security for the existing policyholders of ITAS, and hence the management of ITAS believes in is necessary to carry out the MAP to ensure acceptable levels of capital in ITAS.

9.10 To the extent that ITAS policyholders currently benefit from the (additional) protection afforded by the National Guarantee Fund for Road Accident Victims they will continue to do so after the implementation of the Scheme.

Conclusion

9.11 ***I believe that the Scheme will not have a materially adverse impact on the financial strength (derived from excess assets and reserve strength) enjoyed by the current policyholders of ITAS after the proposed Scheme compared to both their current position and their projected position at the Effective Date (subject to the MAP being successfully implemented).***

Change in Risk Exposure in ITAS

9.12 As mentioned in paragraph 9.7 above, if the Scheme is sanctioned, the gross Technical Provisions of the Transferring Business are forecast to represent a material proportion (circa 75%) of the overall ITAS Technical Provisions at the Effective Date. Thus, all other things being equal, this represents a potentially material change in risk exposure in ITAS as a result of the Scheme.

9.13 However, the Transferring Business will, in large part, have a similar risk profile to that of the current ITAS business, as both entities write predominantly Italian personal and commercial lines business, particularly the MTPL line of business.

9.14 Furthermore, the risk profile of the portfolio within ITAS (post-Scheme) compared to that of the portfolios of the Transferring Business or the current business of ITAS in isolation, would be expected to improve, because of the benefit of the diversification of the portfolio of risks, thereby reducing the volatility of the claims experience. As such ITAS (post-Scheme) would be expected to have both more stable earnings and to suffer proportionately smaller reserve deteriorations than for any one portfolio taken individually.

Conclusion

9.15 ***I am satisfied that, although the Scheme will lead to a change to the risk exposures of the current business of ITAS after the proposed Scheme, this will not have a materially adverse impact on the security of policyholder benefits***.

Policy Servicing Levels in ITAS

9.16 The administration of the existing business of ITAS will be essentially unchanged as a result of the Scheme.

9.17 As described in paragraph 4.26 above, ITAS has an ethical code requiring correctness, honesty and professionalism in all its dealings with its clients. It also has a special committee overseeing the process of customer complaints with the specific role to ensure that the satisfaction of dissatisfied customers is seen as a priority task. None of these areas of conduct will change as a result of the Scheme.

9.18 The policyholders of ITAS have rights of access to IVASS in relation to complaints, and those rights will not be affected by the Scheme.

Conclusion

9.19 ***I believe that the Scheme is unlikely to have an adverse impact on the policy servicing levels enjoyed by the policyholders of ITAS remaining after the proposed Scheme compared to both their current position and their projected position at the Effective Date***.

Membership Rights

9.20 In accordance with the PRA's Statement of Policy and SUP18, I am required to comment on the effects of the Scheme on the proprietary rights of members of mutual companies involved in the Scheme. The proprietary rights of members of ITAS consist primarily of their ability to vote for delegates who can represent them and vote at shareholder meetings. These proprietary rights will not be affected as a result of the Scheme, and as such no compensation will be payable to the policyholder-members.

9.21 Furthermore, there will be no dilution of the rights of the existing members on the Effective Date as the policyholders of the Transferring Business will not become members until and unless they renew their policy with ITAS. Whilst it is expected that many policyholders will go on to renew their policies and hence become members of ITAS, to the extent that this increases the membership of ITAS significantly, the Company By-laws of ITAS allow for the appointment of additional delegates to vote at shareholder meetings. The number of members of ITAS is in any case fluid, changing over time depending on the amount of business ITAS writes. Regardless, I do not consider that any diminution of the proprietary membership rights that could result from the Scheme will materially adversely affect the existing policyholders of ITAS as the membership rights in themselves provide no additional security to the members.

Conclusion for the ITAS Policyholders

9.22 ***For the reasons discussed above, I am satisfied that the Scheme will not have a materially adverse effect on the security service levels or membership rights of the existing ITAS policyholders.***

10. OTHER CONSIDERATIONS

The Likely Effects of the Scheme upon Reinsurers of RSAI and SIO

10.1 In accordance with the PRA Statement of Policy and SUP 18, I have considered the likely effects of the Scheme on the reinsurers whose reinsurance contracts are to be transferred by the Scheme from RSAI and SIO to ITAS.

10.2 The reinsurance asset associated with the Transferring Business was €37.8 million as at 31 December 2014, which represented circa 8% of the corresponding gross Technical Provisions.

10.3 It is proposed under the Scheme that the external reinsurance arrangements be included in the Scheme, and will therefore transfer by virtue of the Court Order and continue to protect the Transferring Business. I note that the external reinsurance contracts transferring under the Scheme are specific to the Transferring Business, and that they are all governed by Italian law.

10.4 I have considered whether the Scheme is likely to lead to any changes in the rights of set-off for creditors or debtors of SIO, RSAI and ITAS involved in the Scheme. Since the existing business of ITAS and the Transferring Business have external reinsurance, and the existing business of ITAS and the Transferring Business also includes inwards reinsurance policyholders, there is the possibility of changes in the right of set-off on the insolvency of ITAS post-Scheme. The chances of insolvency of ITAS are, however, remote (particularly in the short-term) and the volumes of inwards reinsurance are small for ITAS and the Transferring Business (in each case less than 2% measured by gross written premiums in 2014). As such I do not believe the right of set-off affects my conclusions on the impact of the Scheme on reinsurers.

10.5 As described in paragraph 10.3 above, the external reinsurance arrangements will transfer under the Scheme and continue to protect the Transferring Business. The amount of the liabilities of each external reinsurer of SIO, RSAI or ITAS will not change as a result of the Scheme. For this reason, and taking into account my comments in paragraph 10.4 above regarding rights of set-off, I do not consider the existing external reinsurers to be materially impacted by the Scheme.

Conclusion for the Reinsurers of RSAI and SIO whose contracts of reinsurance are to be transferred by the Scheme

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

The Approach to Communication with Policyholders

10.7 Regulations made under the FSMA require a communication regarding the proposed transfer to be sent to every policyholder of the parties to the Scheme. 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 SUP 18.2.46G, the companies would be expected to notify the policyholders, or interested persons, at least six weeks before the date of the Court hearing at which the application to sanction the Scheme will be heard. The companies intend to comply with this guidance.

10.8 I set out my understanding of the companies' proposed approach to communicating the Scheme to affected policyholders below.

10.9 For existing (non-transferring) policyholders of RSAI no direct communication will be undertaken, because:

- Measured both by reference to the number of transferring policyholders and the gross and net technical provision, the transfer of business is not material to RSAI (or RSAIG) and does not impact on other RSAI policyholders (see Section 8).;
- The transferring policyholders are mainly in Italy, with a negligible proportion of commercial customers in other European countries; and

- To extend the communications to all RSAI policyholders would cost in excess of £6m, which is considered disproportionately expensive given the benefits and potential risk of confusion.

10.10 For transferring policyholders of RSAI and SIO, individual communication will be undertaken to policyholders who hold "live" policies and to policyholders who do not hold "live" policies but have active claims, in both cases whose names and addresses are held on the RSAI/SIO systems as at 29 June 2015.

10.11 Individual communication will also be undertaken in respect of existing policyholders of ITAS who are not transferring (except for holders of expired policies of ITAS where claims are not time barred, but where no current claim is in motion), whose names and addresses are held on ITAS's systems as at 29 June 2015.

10.12 RSAIG will operate a dedicated section of its website on which a summary of the Scheme, a summary of this Report and a full copy of this Report will be posted from the date that the posting of individual notices to transferring policyholders commences until 6 months after the proposed Scheme is sanctioned. A link to this section of RSAIG's website will be provided on ITAS's website. ITAS and RSAIG will also make joint notifications of the Scheme in a number of Italian newspapers, and regulatory approvals in relation to the Scheme will be published in IVASS's Bulletin.

10.13 The notification process will also be supported by general publicity and advertising as follows:

- Notice of the intention to apply for approval of the Scheme will be advertised in the London, Edinburgh and Belfast Gazettes, and an Italian translation will be published in the Italian Official Gazette (Gazzetta Ufficale);
- Notice of the intention to apply for approval of the Scheme will be advertised in UK national newspapers (the Times, Financial Times and Daily Mail) and trade journal (Insurance Times, Insurance Day and Post magazine).
- Notice of the intention to apply for approval of the Scheme will be advertised in Italy in specified newspapers (Il Sole24Ore, L'Adige and Trentino);
- Additional advertisements will be placed in other EEA states based on advice provided to RSAIG by their legal advisers (in relation to the Scheme);
- RSAIG and ITAS will operate dedicated websites on which a summary of the Scheme, a summary of this Report and a full copy of this Report will be posted;
- RSAIG and ITAS will operate dedicated helpline numbers and call handlers to deal with queries relating to the proposed Scheme.

10.14 I have been provided with drafts of the true size press notices and have received details of where they are intended to be placed in these publications. The size, prominence, location and language used in these notices appears to me to be not unreasonable.

10.15 Notification will also be made directly to third party intermediaries of the Transferring Business who have terms of business with either RSAI or SIO as at 29 June 2015 or had terms in place during the two years prior to 29 June 2015.

10.16 Regulations made under the FSMA also require all reinsurers of the transferring business to be notified of a proposed transfer. RSAI and SIO propose to directly notify all reinsurers listed in Schedule 3 to the Scheme and of which they have a record of having placed reinsurance in Italy (whether directly or through brokers) and all reinsurers with whom they have an existing treaty reinsurance policy or facultative reinsurance policy or with whom they have existing claims which relate solely to the Transferring Business. Those reinsurers will be notified of the fact that the reinsurance agreements relating to the transferring policies are proposed to be transferred pursuant to the Scheme and that it is proposed that ITAS will be party to those agreements in place of RSAI or SIO as relevant after the Scheme has become effective. The reinsurers will also be provided with details of the final hearing of the application to the Court.

10.17 It will ultimately be for the Court to decide what notifications are required. This will be decided at a court hearing after this Report is finalised and will be subject to any amendments required by the Court. It is possible, therefore, that the actual approach to policyholder notification may differ in some respects from that proposed and outlined above.

10.18 When thinking through the proposed approach to notifications, I have considered a number of factors, including whether the policyholders in either RSAI, SIO or ITAS are likely to be interested in being informed of the proposed Scheme. In this context, I believe that the approach to policyholder notifications needs to consider the likelihood of a policyholder having a claim, whether the policyholder's policy is transferring and the impact of the Scheme on security. These issues need to be weighed-up against the risk of policyholder notifications causing confusion or annoyance in relation to an issue that policyholders may consider to be insignificant. The practicability of notifying policyholders also needs to be taken into account.

10.19 ***Based on my considerations (as outlined above), I believe the proposed approach to communication with policyholders and reinsurers (as the case may be) to be both proportionate and reasonable***.

Assets and Liabilities of ITAS and the Transferring Business

10.20 As at 31 December 2014, the assets associated with the Transferring Business comprised of: Euro denominated investments (valued at €296.3 million); cash or cash equivalents (valued at €77.7 million); debtors (valued at €110.2 million); outwards reinsurance contracts (i.e. the reinsurance asset valued at €37.8 million); and other assets (valued at €40.2 million). The characteristics of the investments (totalling €296.3 million) were as follows:

- Fixed interest instruments made up of Corporate Bonds; Government Bonds/Treasuries and Securitizations making up 70%, 25% and 5% of the portfolio by value respectively;
- The average duration and gross redemption yield is circa 2.5 years (i.e. short-dated) and circa 0.5% per annum respectively;
- Of the fixed interest instruments circa 99% of the portfolio by value was investment grade (BBB or better);
- The currency split is 99% in Euro and 1% in US dollars.

10.21 As noted in paragraph 10.3 above, the reinsurance contracts to be transferred under the Scheme are governed by Italian law. Where such contracts are not governed by UK law, there is a risk that reinsurers may challenge the Scheme and refuse to continue to meet their obligations under the reinsurance contracts. However, based on advice from the legal advisers to RSAI (in relation to the Scheme), Italian Courts should recognise the proposed Scheme if sanctioned by the Court. Thus I do not consider there to be a material (if any) risk of challenge to the transfer of the external reinsurance contracts, and as such had the Scheme been implemented as at 31 December 2014, the reinsurance asset valued at €37.8 million should have transferred alongside the other transferring assets.

10.22 As at 31 December 2014, ITAS had investments with an Italian GAAP book value of €710.3m and a market value of €777.4m (the large unrealized gains mainly relate to fixed interest investments in the light of the falls in long-term interest rates and reductions in sovereign spreads on Italian Government bonds which occurred during 2014 and which have continued in 2015).

10.23 On a market value basis, circa: 54% of the investments are in Italian Government bonds; 2% in other Eurozone Government bonds; 11% in corporate and bank bonds; 2% in equities and 5% in mutual funds. The remaining 26% of investments are in participations in the subsidiaries ITAS Spa, ITAS Vita, Val Piave and the real estate company.

10.24 As at 31 December 2014, the average duration for the bonds is circa: 6 years for Italian government bonds, 7 years for the other Euro government bonds, 2 years for the financial sector corporate bonds and 6 years for other corporate bonds, in each case within the ITAS portfolio. Circa 97% of the portfolio by value was investment grade (BBB or better).

10.25 The assets associated with the Transferring Business under the proposed Scheme will be equal to the value of the liabilities associated with the Transferring Business, as at the Effective Date on an IFRS basis. The composition of the assets to be transferred had the Scheme taken place as at 31 December 2014 is shown in Table 5.1 above.

10.26 Had the proposed Scheme taken place as at 31 December 2014, the gross (of reinsurance) Technical Provisions of ITAS post-Scheme entity would have amounted to €1.2 billion, which would have been covered by a combination of ITAS post-Scheme assets (investments, cash, reinsurance ceded and debtors). Further, the investments (underlying the Transferring Business) would have been essentially Euro denominated Italian bonds with the characteristics outlined in paragraph 10.20 above. Therefore, in my view, the nature and quality of the investments transferring to ITAS would not be materially different to the nature and quality to the investments in ITAS pre-Scheme, while noting that they are of shorter duration. Further, ITAS post-Scheme would maintain a broadly matched position relative to its liabilities.

10.27 ***In my view the type and nature of the assets associated with the Transferring Business does not generate any material additional risk to the security of the policyholders of ITAS, including the policyholders of the Transferring Business***.

Operational Plans and Changes in Assets and Liabilities up to the Effective Date

10.28 I expect that the current activities of RSAI, SIO and ITAS will continue between 31 December 2014 and the Effective Date (and, as appropriate, after the Effective Date). RSAI, SIO and ITAS will continue to write new business, and the companies will continue to settle claims and reassess reserves in the light of experience. I do not consider that any material additional risk to any group of affected policyholders will emerge as a result of the continuation of normal business.

10.29 Further to considering the continuation of normal business, I have discussed with RSAIG and ITAS the possibility of management actions, other than the proposed Scheme, as considered in this Report, that could affect the financial position of RSAI, SIO and ITAS (such as significant changes in new business strategy or operational plans). I have been informed that both RSAIG and ITAS have no planned activities that would have a material effect on the security of their policyholders, either for those that were policyholders as at 31 December 2014 or those that have become policyholders since then.

10.30 I believe that it is unlikely that any events occurring between 31 December 2014 and the Effective Date would affect any conclusion that I reach based on my review as at 31 December 2014.

10.31 A short time before the final Court hearing, I will consider the extent to which the operational plans of RSAI have altered (relative to the position at the Date of this Report) and the actual changes in assets and liabilities (relative to the position as at 31 December 2014) and hence whether there have been any changes (including those associated with current economic conditions) that would affect my overall opinion, and if necessary, I will report on these separately.

Solvency II

10.32 As described in Section 2, the regulatory solvency reporting requirements for EU insurers and reinsurers will undergo a major overhaul with effect from 1 January 2016.

10.33 As the Scheme is expected to become effective either before or coincident with when the Solvency II regime comes into force (i.e. 1 January 2016), it is anticipated that SIO will not be required to comply with Solvency II requirements. My comments therefore focus on RSAI and ITAS, while noting that pre-Scheme, SIO is still being included within the overall Solvency II implementation plan of the relevant entities of RSAIG.

RSAI

10.34 RSAI/RSAIG launched its Solvency II programme in 2011 within which it established centrally a number of work-streams with the aim of designing and coordinating the delivery of the Solvency II solution across relevant RSAIG businesses. During 2014, RSAIG performed a group-wide gap analysis that led to an updated view of the End State Operating Model ("ESOM") to be in place by 1 January 2016.

10.35 The components of ESOM are structured around the three pillars of Solvency II broadly as follows:

- Pillar 1
    - Capital Management
    - Internal Model
    - Actuarial Function (including Technical Provisions)
- Pillar 2
    - Risk Management System (including the ORSA)
    - Corporate Governance
    - Internal Control Systems
    - Risk Management, Compliance and Internal Audit Functions
    - Internal Model Governance and Validation
- Pillar 3
    - Solvency II Balance Sheet (other than Technical Provisions)
    - Reporting (quantitative reporting templates and regulatory reports).

10.36 In addition to the components of ESOM (outlined in paragraph 0 above) there are a number of key (formal) committees established (under Pillar 2) by RSAIG to oversee the implementation of ESOM, these include the: Group Executive Committee, Group Reserving Committee, Internal Model Governance Committee etc. In turn these committees report into RSAIG and Board Committees and through them ultimately to the RSAIG Board.

10.37 I have reviewed the Solvency II (ESOM) implementation programme by key activities in terms of the accountability structure both at an ownership and operational level, and the deliverables (at the date of this Report). I have also held discussions with key personnel within RSAIG on its Solvency II implementation programme.

10.38 A crucial deliverable in the RSAI/RSAIG Solvency II implementation programme is approval of the Internal Model under IMAP. I have held discussions with key members of the IMAP team to discuss both the model and the application process. RSAI/RSAIG made its application on 2 June 2015, with a final decision on approval anticipated some six months later.

10.39 Overall, based on my conversations and my review of the materials I have received, and noting the successful delivery of the internal model application on 2 June 2015, I have not identified any reasons why RSAI/RSAIG (including SIO if applicable) should not be able to meet its Solvency II programme in time for implementation on 1 January 2016. Nonetheless, I intend to review RSAIG's progress towards Solvency II implementation on 1 January 2016 and report on the findings of my review in my Supplementary Report to the Court (see paragraph 1.30 above).

ITAS

10.40 ITAS is working towards the full implementation of Solvency II in time for the deadline for the new rules to go live on 1 January 2016. Furthermore, the Integration Committee charged with integrating the Transferring Business within ITAS is focused on the importance of being able to meet this deadline in respect of the total business including the Transferring Business.

10.41 There is high level engagement on Solvency II implementation within ITAS, e.g. the person with overall responsibility for the Solvency II project reports directly to the Board.

10.42 The Solvency II project within the ITAS Group is managed around the three pillars of Solvency II broadly as follows:

- Pillar 1 (quantitative) requirements are focussed in four broad areas: Non-Life, Life, Assets/Finance and the Economic Balance Sheet. Based on discussions with relevant personnel within ITAS (and review of applicable materials), all Pillar 1 items are at an advanced stage of readiness, either complete or close to completion;
- Pillar 2 requirements are focussed in two broad areas: Governance and the Risk Management Framework, and the ORSA. Based on discussions with relevant personnel within ITAS (and review of applicable materials), the Pillar 2 qualitative items are close to full readiness, whereas further work is needed on the quantitative items, particularly in relation to the receipt of the Transferring Business; and
- Pillar 3 reporting requirements are focussed in two main areas IT and data to ensure the successful delivery of data quality, a data catalogue, QRTs and regulatory reports. Based on discussions with relevant personnel within ITAS (and review of applicable materials), the Pillar 3 items are at various stages of readiness ranging from nearly complete to relatively early development.

10.43 As part of the company's Risk Management Framework, it is currently proposed that, whilst the Solvency II cover ratio will be targeted at a higher level, the company's minimum level is set at 122% of the SCR over a one year time horizon (i.e. the company would take appropriate actions to restore its capital position if the Solvency II cover ratio falls below 122%).

10.44 A key part of the ITAS/RSAI integration plan is the delivery of a Solvency II compliant platform in respect of the Transferring Business. This deliverable has been scoped, analysed and a plan of action established for each of the three pillars of Solvency II. It is now in the implementation stage and due for completion by mid-October 2015. Based on my conversations with key members of the team to discuss the Solvency II aspects of the integration process, review of applicable materials, and progress-to-date (against plan) I have formed the view that ITAS should meet the deadline of being able to deliver a Solvency II compliant platform for the Transferring Business in an orderly manner by the Effective Date.

10.45 Overall, based on conversations and my review of the materials I have received, and subject to meeting the requirements for the orderly integration of the Transferring Business, I have not identified any reasons why ITAS (and the wider ITAS Group) should not be able to meet its Solvency II programme in time for implementation on 1 January 2016. Nonetheless, I intend to review the ITAS Group's progress towards Solvency II implementation on 1 January 2016 and report on the findings of my review in my Supplementary Report to the Court (see paragraph 1.30 above).

Conclusion

10.46 ***I am satisfied that the Scheme does not increase the overall Solvency II compliance risk in RSAI, nor will it impact the RSAI approach to meeting and complying with Solvency II requirements.***

10.47 ***The Scheme does alter the overall Solvency II compliance risk in ITAS, but in the context of ITAS being in a position to be fully compliant from 1 January 2016, not in a materially adverse manner for the policyholders of ITAS (including the policyholders of the Transferring Business).***

Tax

10.48 I am informed that the Scheme is not expected to have tax implications that would affect any policyholders impacted by the transfer under the Scheme.

What would happen were the Scheme not to proceed?

10.49 The BSTA has a "long-stop date" of 30 June 2016. If the Scheme is not sanctioned by that date the BSTA will, unless the parties agree otherwise, terminate. In these circumstances the Transferring Business would remain with RSAIG and would continue to be administered in the same way as it is currently. I have concluded above that the policyholders of RSAI and SIO (including those of the Transferring Business) currently benefit from the security afforded by a more than sufficiently capitalised company, and this will not change if the Scheme is not sanctioned.

10.50 Given its desire to focus on its core business areas (as noted in paragraph 5.1 above), if the Scheme is not sanctioned, RSAIG would need to consider its options in relation to the future running of the Transferring Business.

10.51 If the Scheme is not sanctioned, ITAS would likewise continue to operate as currently. I have concluded above that the policyholders of ITAS currently benefit from the security afforded by a well-capitalised company, and this will not change if the Scheme is not sanctioned. To the extent that the MAP is implemented prior to the transfer being abandoned, the policyholders of ITAS will benefit from the additional security afforded by the subordinated loan and any additional reinsurance protections purchased.

10.52 If the Scheme is not sanctioned, costs already incurred in the sale process would be shared between the parties as per the BSTA.

11. CONCLUSIONS

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

- The security of benefits to policyholders of RSAI, SIO and ITAS will not be materially adversely affected by the implementation of the Scheme on the Effective Date, subject to the successful implementation of the MAP by ITAS; and

- The Scheme will have no impact on service standards experienced by the policyholders of RSAI, SIO and ITAS provided, in the case of the transferring policyholders of the Italian branch of RSAI, that plans are finalised ahead of the Court hearing to sanction the Scheme to ensure that satisfactory systems will be in place at ITAS to service the multinational business from the Effective Date and thereafter.

11.2 In reaching this opinion I have applied the following principles (as set out in the Transformations TAS):

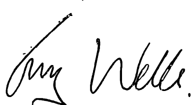
- I have considered which parties might be affected by the Scheme and in what way. I have documented my findings.

- Although I have not performed my own modelling, rather I have relied on the results of models developed and operated within RSAI, SIO and ITAS, I have reviewed documentation describing the models, describing and justifying the assumptions underlying those models, and explaining the derivation of the data underlying the models and assumptions, in particular explaining how its accuracy, completeness and relevance has been verified.

- To the best of my knowledge there are no beneficiaries for whom the impact of the Scheme has not been considered.

- I have considered how the Scheme might lead to any changes in the material risks to the benefits of the different interested parties.

- I have considered the impact on the actuarial information provided to me of RSAI, SIO and ITAS having adopted alternative plausible assumptions, for example in the scenario and sensitivity tests within the SCR calculation.



Gary Wells / 24 June 2015

Fellow of the Institute and Faculty of Actuaries

APPENDIX A DEFINITIONS

Term	Definition
Admissible Assets	Assets valued in accordance with applicable regulations, which can be taken into account for the purposes of demonstrating that a general insurance company meets its solvency requirements.
Correlation	Correlation (in the context of the Report) is a number that describes the statistical relationship between two variables (e.g. equity prices and interest rates).
Enhanced Capital Requirement ("ECR")	A more risk sensitive capital requirement (than the MCR) for UK insurers as measured by the PRA.
Equalisation Reserve	An equalisation reserve is a reserve built-up (generally from profitable years) as a cushion against periods with worse than average claims experience.
PRA Returns	Accounts, balance sheets, abstracts and statements relating to the business of an insurance company required under PRA rules to be submitted periodically to the PRA. Prior to May 2013, companies were required to submit this information to the FSA.
International Financial Reporting Standards ("IFRS")	A common global language for business affairs so that company accounts are understandable and comparable across international boundaries.
Individual Capital Assessment ("ICA")	An insurance company's own assessment of the capital it needs for regulatory purposes in order to mitigate appropriately the risks to which it is exposed and that could otherwise cause it to be unable to meet its liabilities as they fall due.
Individual Capital Guidance ("ICG")	The PRA's assessment of the minimum level of capital that it would expect an insurance company to hold based on its view of the insurance company's ICA and risk management framework.
Minimum Capital Requirement ("MCR")	Required minimum level of capital under Solvency I rules. See Appendix D for further details.
Reinsurance	An arrangement with another insurer whereby risks are shared (or passed on).
Solvency I	The system for establishing minimum capital requirements for EU insurers under relevant EU Directives presently in-force.
Technical Provisions	Liabilities determined for regulatory purposes. In particular, the provisions for the ultimate costs of settling all claims arising from events which 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 arising on unexpired periods of risk.

APPENDIX B LIST OF PREVIOUS TRANSFERS FOR WHICH GARY WELLS HAS ACTED AS THE INDEPENDENT EXPERT OR EQUIVALENT

1997: Transfer of the PHI business from Norwich Union Limited to Norwich Union Life & Pensions Limited

1997: Transfer of business from Security Assurance Limited to Norwich Union Life & Pensions Limited

1999: Transfer of the business of London & Edinburgh Life to Norwich Union Life & Pensions Limited

2004: Transfer of the business of the Continental Reinsurance Company (UK) Limited to Continental Management Services Limited

2005: Transfer of the business of the UK branch of the Continental Insurance Company to Continental Management Services Limited

2006: Transfer of the IGI portfolio of CX Reinsurance Company Limited to CNA Insurance Company Limited

2008: Transfer of the Irish branch business of Royal & Sun Alliance Insurance plc to Europa General Insurance Company Limited

2009: Transfer of business from Arran Insurance Company Limited to Chevanstell Limited

2010: Transfer of business from Euler Hermes Guarantee plc to Euler Hermes UK plc

2011: Transfer of business from Euler Hermes UK plc to Euler Hermes Belgium

2011: Transfers of business from PA(GI) Ltd to Royal & Sun Alliance Insurance plc and Marine Insurance Company Limited

2011: Rationalisation of 22 UK regulated entities of Royal & Sun Alliance Insurance plc to 5 UK companies via 3 Part VII transfer schemes (effective 1 January 2012)

2013: Transfer of certain business of the Italian branch of Sompo Japan Insurance Company of Europe Limited to Berkshire Hathaway International Insurance Limited.

2013: Transfer of the European branch business of MSIEu to MSIG AG.

2013: Transfer of the business Chevanstell Limited to R&Q Insurance (Malta) Limited.

APPENDIX C TERMS OF REFERENCE

The Independent Expert report will consider the terms of the Scheme generally and the effect which the Scheme will have on the holders of insurance policies issued by the Companies *(i.e. RSAI, SIO and by ITAS)*.

The Independent Expert's review and report will address generally the way in which the Companies have conducted their insurance business but taking into account the particular circumstances of each class of business to be transferred. In summary the review and report will consider the merits of the Scheme from the perspective of each of the groups of policyholders affected by the Scheme and deemed to require separate consideration. This will involve any policyholders remaining in the Transferors or (if any), policyholders being transferred and the policyholders of the Transferee.

The Independent Expert will carry out the work necessary to enable the Independent Expert to form an opinion on the Scheme. This is likely to include, amongst other things, all or part of the following:

A. Production and provision of a data request detailing the information Milliman requires from the Companies in order to provide services under the Scheme.

B. Support to the Companies' dialogue with the Regulators and provision of information required by that dialogue including:

- information about the Independent Expert, Milliman and its clients in order that the Regulators may assess whether it is appropriate for Milliman to carry out this work; and

- information to enable the Regulators to assess whether the proposed Independent Expert is suitably qualified for the role.

C. Agreement of the scope of Milliman's work with the Regulators, including the provision of the documented agreed scope.

D. For each of the Transferors and Transferee listed in Schedule 1, an analysis (where necessary) of the:

- liabilities being transferred (including reserves for incurred but not reported claims, unearned premium reserves and any additional reserve for unexpired risks), including the likely scope for deteriorations in the technical reserves (i.e. the likelihood and extent to which reserves may prove inadequate);

- assets in respect of outwards reinsurance;

- bad debt provision in relation to outwards reinsurance;

- allocation of reinsurance protection to different groups of policyholders, if appropriate;

- other assets and liabilities to be transferred;

- current profitability; and

- exposure to catastrophic losses.

E. Comparison of the solvency positions of the Companies listed in Schedule 1, including consideration of any intra group reinsurance contracts and/or guarantees that may be provided, with the aim of comparing the current solvency position with the anticipated solvency position immediately after the Scheme is implemented and after other planned material corporate changes that the Companies have advised to the Independent Expert are completed. The consideration of the solvency position of these companies is expected to be carried out by comparing available capital against regulatory minimum capital based on Solvency I, ICA (as appropriate) and Solvency II (as presently understood) regulations, and taking into account the qualitative and quantitative aspects of these solvency regimes (using, but not limited to, the Companies' internal models for ICA and Solvency II purposes) produced by the Companies for the Transferors and Transferee (as necessary).

F. Analysis of publically available information on the financial strength of each of the Transferors and Transferee, where available, including rating agency reports, analysts' reports annual report and accounts and financial statements.

G. Analysis of the effect of the Scheme on non-financial aspects, including existing policyholder service levels and agreements, for the policyholders remaining in the Transferors (if any), policyholders being transferred and the policyholders of the Transferee.

H. Discussion with the Companies regarding the initial findings in respect of the Scheme, which may involve the provision by Milliman of exhibits documenting various findings from its work including where appropriate, but not limited to, work carried out in items D to G above.

I. Discussion with the Regulators as required, in line with the discussions with the Companies in item H above.

J. Production of the Report, for submission to the Court.

K. Production or approval of a summary of the Independent Expert Report that forms part of the Scheme summary for inclusion within letters to policyholders.

L. Production of the Independent Expert Update Report, for submission to the Court.

M. If required attendance at Court hearings. For the avoidance of doubt, Milliman's fee estimates included in this agreement include its attendance at an uncontested Court hearing. Its costs associated with attendance at Court for additional Court hearings or those extended owing to parties contesting the proposed Scheme, and for its preparation time for contested hearings will be charged in addition at our hourly rates (as set out in Schedule 4).

Milliman will liaise with the Companies and their professional advisors where necessary, in order to complete its work under the Scheme. The Independent Expert will request from the Companies the information required by the Independent Expert which is necessary to complete his work.

APPENDIX D KEY SOURCES OF DATA

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

Legal documents

- Draft Scheme document
- Draft Witness Statements and other Court documents
- A copy of the Business Sale and Transfer Agreement between RSAI SIO and ITAS concerning the Transferring Business ("RSA Italy").

Financial returns and performance

- PRA Returns for RSAI for the years-ended 31 December 2013 and 2014
- Financial Statements for RSAI, SIO and ITAS for the 2013 and 2014 year-ends
- Management accounts for RSA Italy as at end of Q4 2014

Solvency / Capital information

- RSAIG's 2014 Capital Report, as at 31 December 2013
- Update documents setting out RSAI's projected ICA and SCR model results as at 31 December 2014 (and 2015)
- RSAI's ECR return as at 31 December 2013 and 2014
- ITAS Solvency I calculations showing MCRs and Capital Resources on solo and Group bases pre and post-merger with RSA Italy as at 31 December 2014
- ITAS standard formula spreadsheets showing the calculations of Solvency II SCRs and Own Funds on solo and Group bases pre and post- merger with RSA Italy as at 31 December 2014.

Reserving

- "UK Reserve Assessment" actuarial reports for RSAI as at year-ends 2013 and 2014 (based on data as at the end of the previous September)
- An internal actuarial report, as at 31 December 2013, for RSA Italy
- Internal documents providing commentary on the reserves for RSAI and RSA Italy as at 31 December 2014
- External actuarial report, as at 31 December 2013, commissioned by RSAI in respect of RSA Italy
- External actuarial reports concerning the UK asbestos reserves of RSAI as at 31 December 2014
- External actuarial reports on the reserves of ITAS as at 31 December 2013
- An internal ITAS memo concerning the reserves of ITAS as at 31 December 2014

Outwards reinsurance

- A document setting out RSAI's and RSA Italy's outwards reinsurance programmes
- A document setting out ITAS's outwards reinsurance programmes

Miscellaneous

- A document commissioned by RSAI giving a comparative analysis of consumer (policyholder) protection between the UK and Italy

- RSAI note (dated March 2015) setting out progress towards Solvency II internal model approval, and updated 2014 Q4 results
- RSAI notes (April 2015) on Solvency II implementation – plan (showing milestones and deliverables) and approach to governance
- Minutes of the RSAI/ITAS Integration Committee (through to April 2015)
- Minutes of the RSA Italy Solvency II Steering Committee (through to April 2015)
- ITAS's Corporate By-laws (in English)

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

APPENDIX E MINIMUM CAPITAL REQUIREMENT FOR GENERAL INSURANCE BUSINESS AS AT THE 2013 YEAR-END

E.1. In the UK, the process of setting minimum solvency margins changed with effect from 2005. However, UK general insurers remain subject to statutory requirements based on EU Directives and, for the time being, provide their risk-based enhanced capital requirement ("ECR") calculation to the PRA. In addition, all UK general insurers are required to make individual capital assessments ("ICAs") of their own capital needs, which will be used by the PRA when giving individual capital guidance ("ICG").

E.2. The minimum capital requirement ("MCR"), based on EU Directives, is calculated as the greater of:

- a premium measure
- a claims measure
- a prior year MCR measure
- a minimum amount, currently set at €3.7 million.

E.3. The premium measure (A) is based on gross adjusted premiums (P) as follows:

- If P ≤ €61.3 million then A1 = P x 18%, A2 = 0
- If P > €61.3 million then A1 = €11.034 million, A2 = (P - €61.3 million) × 16%
- A = A1 + A2

E.4. The claims measure (B) for other than health insurance is based on gross adjusted incurred claims (C) as follows:

- If C ≤ €42.9 million then B1 = C × 26%, B2 = 0
- If C > €42.9 million then B1 = €11.154 million, B2 = (C - €42.9 million) × 23%
- B = B1 + B2

E.5. A credit for reinsurance factor (r) is then determined as the ratio of net incurred claims over the 3 year period (to the valuation date) to gross incurred claims ratio over the same 3 year period. If r < 0.5 then r is set to 0.5.

E.6. The prior year MCR measure (M) is based on the MCR as at the prior financial year-end and changes in outstanding claims:

- Where net outstanding claims are greater than zero as at the end of the current and previous financial years then M = Prior year MCR × min(1, net outstanding claims as at the end of the current financial year divided by the net outstanding claims as at the end of the previous financial year);
- Where net outstanding claims are zero as at the end of the current and previous financial years then M = Prior year MCR × min(1, gross outstanding claims as at the end of the current financial year divided by the gross outstanding claims as at the end of the previous financial year);
- Where gross outstanding claims are zero as at the end of the current and previous financial year then M = MCR as at the end of the previous financial year.

E.7. Minimum solvency margin = max {max (A,B) × r, M, €3.7million}

E.8. For the purposes of this calculation, inwards reinsurance business is treated as insurance business.

E.9. The currency amounts within this calculation are subject to periodic revision.

E.10. The minimum capital requirement for an insurer in Italy is calculated as described above for the UK. There are no further regulatory requirements. However, as will also apply in the UK, Italian insures will be required to establish capital levels in accordance with the EU-wide Solvency II regime with effect from 1 January 2016.