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Report by Simon Sheaf FIA, Independent Expert, on the Proposed Transfer of a Portfolio of Policies from Arch Insurance (UK) Limited to Arch Insurance (EU) dac

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Contents

1 Introduction

1.1 Insurance business transfers in the United Kingdom are subject to Part VII of the Financial Services and Markets Act 2000, as amended ("FSMA"). These transfers are required to be approved by the High Court of England and Wales (the "Court") (or the Court of Session in Scotland) under Section 111 of FSMA. Such transfers are often referred to as Part VII transfers.

1.2 Section 109 of FSMA requires that a scheme report must accompany an application to the Court to approve an insurance business transfer scheme. This scheme report should be produced by a suitably qualified independent person ("Independent Expert") who has been approved by or nominated by the Prudential Regulation Authority ("PRA") in conjunction with the Financial Conduct Authority ("FCA"). The scheme report should address the question of whether any policyholders impacted by the proposed insurance business transfer are adversely affected to a material extent.

1.3 Arch Insurance (UK) Limited ("AIUK") and Arch Insurance (EU) dac ("AIEU") have jointly nominated Simon Sheaf ("I" or "me") of Grant Thornton UK LLP ("Grant Thornton", "we" or "us") to act as the Independent Expert for the proposed insurance business transfer of a portfolio of insurance business from AIUK to AIEU ("the Scheme"). This nomination has been approved by the PRA in consultation with the FCA.

1.4 If approved by the Court, the Scheme is intended to take effect on 31 December 2020 ("the Effective Date").

1.5 The terms of my engagement are set out in a letter dated 8 January 2020. An extract of this letter setting out the scope of my work is included in Appendix F. AIUK is bearing the costs of this scheme report.

Background to the Scheme

Background to AIUK

1.6 AIUK was incorporated in November 2003 as Arch Company (Europe) Limited. AIUK subsequently changed its name to Arch Insurance (Company) Europe Limited in January 2004 and to Arch Insurance (UK) Limited in March 2020.

1.7 AIUK is a wholly owned subsidiary of Arch Reinsurance Europe Underwriting dac (an Irish company) and its ultimate parent is Arch Capital Group Ltd. ("ACGL") a Bermuda exempted company limited by shares. The common shares of ACGL are listed and traded on the NASDAQ Stock Market in the U.S.

1.8 AIUK is authorised by the PRA and regulated by both the PRA and the FCA. Under its current authorisations, AIUK is permitted to sell and administer general insurance contracts across a range of classes of business in the UK as well as several other countries throughout the EEA through its EEA Passporting Rights.

1.9 AIUK's EEA Passporting Rights may no longer exist following the current transition period in respect of the UK's withdrawal from the European Union ("Brexit Transition Period"). AIUK is therefore seeking to transfer its insurance business in the EEA to another entity that will have the appropriate permissions to transact this business after the end of the Brexit Transition Period.

1.10 In anticipation of the end of the Brexit Transition period, AIUK ceased to underwrite new insurance business in the EEA after 31 December 2019 other than a small book of 40 policyholders. Since that date, any EEA business that would have historically been underwritten by AIUK has been underwritten by AIEU which will continue to have the appropriate permissions to transact this business following the Brexit Transition Date.

Background to AIEU

AIEU was incorporated in October 2011 as Arch Mortgage Insurance Limited and changed its form to become a designated activity company with the new name Arch Mortgage Insurance dac on 20 October

2015. In March 2019, Arch Mortgage Insurance dac changed its name to Arch Insurance (EU) dac. AIEU is a wholly-owned subsidiary of Arch Financial Holdings Europe II Limited (an Irish company) and its ultimate parent is ACGL.

1.11 Prior to April 2019, AIEU's sole line of business was credit and suretyship insurance in respect of housing loans advanced by lenders in EU Member States. On 6 March 2019, AIEU received authorisation from the Central Bank of Ireland ("CBI") to expand its insurance licence to cover all classes of insurance business, except Class 18 'Assistance'. The application to the CBI was made in August 2018 as part of AGCL's strategy for the UK withdrawal from the European Union ("Brexit").

1.12 During March 2019, AIEU received permission from the CBI to underwrite insurance business in all EEA and EU Member States under the EU Freedom of Services Acts and to open branches in the UK, Italy and Denmark on a Freedom of Establishment basis.

1.13 AIEU manages its EEA business in three distinct divisions: Mortgage Insurance consisting of AIEU's ongoing business prior to April 2019, Alwyn Europe comprising motor and pet insurance business, and its P&C Division comprising the business that was previously underwritten by AIUK.

The Scheme

1.14 The following business will be transferred to AIEU under the Scheme:

- All policies forming part of the portfolio of general insurance policies of AIUK carried out prior to the Effective Date where the risk associated with such policy is written on a Freedom of Services basis or a Freedom of Establishment basis (the "Transferring Portfolio")
- the outwards reinsurance policies issued to AIUK where these are relevant to or provide protection for a policy referred to in the previous bullet point
- contracts and other commitments to which AIUK is a party at the transfer date and which relate to the policies or reinsurance policies referred to above (this will include the coverholder arrangements currently in place in the various EEA States other than the UK in which risks are located)
- the assets and liabilities (excluding misselling liabilities) relating to each of the above.

1.15 The Scheme excludes the following AIUK policies and this business will not transfer to AIEU ("the Remaining Portfolio"):

- All policies forming part of the portfolio of general insurance policies of AIUK carried out prior to the Effective Date where the risk associated with such policy is not written on a Freedom of Services basis or a Freedom of Establishment basis
- All inwards reinsurance policies

1.16 I understand from AIUK and AIEU that there are currently no policies or reinsurance contracts that will not be transferred to AIEU under the Scheme other than those captured in paragraph 1.15.

1.17 The Scheme is expected to take effect on the Effective Date. The Scheme will lapse if the Scheme has not become effective on or before 31 December 2020, or a later date agreed by AIUK and AIEU and allowed by the Court.

1.18 For the purposes of this report I refer to:

- the policyholders of the Transferring Portfolio as the "transferring policyholders"
- the policies that will remain with AIUK following the Scheme as "the Remaining Portfolio" and the policyholders as the "remaining policyholders"
- the policies that are with AIEU prior to the Scheme as "the Existing Portfolio" and the policyholders as the "existing policyholders".

Layout of this Scheme report

1.19 My report is structured as follows:

- This section sets out an introduction to the Scheme and to this report
- Section 2 is an executive summary, which summarises the Scheme and the various analyses conducted and describes my conclusion
- Section 3 sets out the scope of this report
- Section 4 provides a summary of the methodology I have employed in order to assess the Scheme
- Section 5 describes the background to the entities involved
- Section 6 describes the regulatory background
- Section 7 describes the work that I have carried out to assess the claims reserves of AIUK and AIEU
- Section 8 describes the work that I have carried out to assess the capital requirements of AIUK and AIEU
- Section 9 provides my assessment of the policyholder security considerations, including under insolvency
- Section 10 provides my assessment of other financial considerations
- Section 11 provides my assessment of other non-financial considerations
- Section 12 provides my assessment of the proposed communication strategy for the Scheme
- Section 13 sets out the reliances and limitations that apply to my analysis and this report
- Section 14 sets out my conclusions in respect of the Scheme.

1.20 Definitions of technical terms and explanations of abbreviations used in this report are contained in Appendices B and C, respectively.

Professional Experience

1.21 I am a Fellow of the Institute and Faculty of Actuaries (“IFoA”). I currently hold a Chief Actuary (Non-life with Lloyd's) Practising Certificate and a Lloyd's Syndicates Practising Certificate issued by the IFoA. In addition, I have previously held an Irish Signing Actuary Practising Certificate and have previously been recognised as a Responsible Actuary by the financial regulator in Liechtenstein.

1.22 I joined Grant Thornton's Financial Services Group as General Insurance Practice Leader in 2006. I am a Partner in Grant Thornton and my current job title is Head of General Insurance Actuarial and Risk. I lead the provision of actuarial and risk consulting services to the general insurance sector. Prior to joining Grant Thornton, I held senior roles at Tillinghast – Towers Perrin (now part of Willis Towers Watson plc) and Travelers Insurance Company Limited.

1.23 I have experience in all areas of general insurance actuarial work (including reserving, capital, pricing, transactions, etc). I have previously acted as the Independent Expert for nine other sanctioned insurance business transfer schemes and I am currently acting as the Independent Expert for two other insurance business transfer schemes.

1.24 Further details of my experience can be found in Appendix E.

Independence

1.25 I have no financial interest in AIUK, AIEU or the group of companies to which they belong.

1.26 I have never provided any consulting services or acted in any advisory capacity to AIUK, AIEU or any companies who were at the time in ACGL

1.27 I have provided consulting services to an entity that has subsequently been acquired by ACGL in a professional capacity; however, it was not part of ACGL at the time and I do not believe these previous assignments impair my independence to act as the Independent Expert on the Scheme.

Use of this report

1.28 The purpose of this report is to inform the Court of the likely effect of the Scheme upon policyholders. This report is not necessarily suitable for any other purpose.

1.29 This report is provided for the use of the Court, the AIUK Board, the AIEU Board, AIUK's policyholders, AIEU's policyholders, the PRA, the CBI, the FCA and any other relevant regulator for the sole purpose of considering the impact of the Scheme on the affected policyholders.

1.30 In addition, draft and final versions of this report and the other reports that I produce in connection with the Scheme may be distributed to AIUK's and AIEU's legal advisers and companies within the corporate group to which AIUK and AIEU belong as necessary in connection with the Scheme. Should any of my reports be distributed to any of the entities listed in the previous sentence, no reliance should be placed on my reports by these entities, and we do not accept any responsibility or assume any liability to either these entities or to any other third parties that choose to rely on my reports.

1.31 AIUK shall be responsible for any confidentiality breaches that arise from the distribution of my reports to AIUK's legal advisers, to companies within the group to which AIUK belongs or to any other entities to which it releases my reports. AIEU shall be responsible for any confidentiality breaches that arise from the distribution of my reports to AIEU's legal advisers, to companies within the group to which AIEU belongs or to any other entities to which it releases my reports.

1.32 Copies of the final version of this 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. The final version of this report may also be made available on a website hosted by the Arch Group in connection with the Scheme.

1.33 However, notwithstanding the above, Grant Thornton does not accept any responsibility or assume any liability to any party other than AIUK, AIEU and the Court who chooses to act on the basis of this report.

1.34 Judgements about the conclusions drawn in this report should only be made after considering the report in its entirety as any part or parts read in isolation may be misleading.

1.35 The underlying figures in this report are calculated to many decimal places. As a result, in the presentation of the figures in the various tables, there may be reconciliation differences due to the effect of rounding.

Summary and Supplementary Reports

1.36 I have prepared a summary of this report to be included in the information sent to the policyholders of AIUK and AIEU ("the Summary Report").

1.37 Shortly before the date of the final Court hearing, at which an order sanctioning the Scheme will be sought, I will prepare an update to this report covering any relevant matters which have arisen since the date of this report ("the Supplementary Report").

1.38 I consent to the final versions of my Summary Report and Supplementary Report being made available on the website to be hosted by AIEU in connection with the Scheme.

1.39 However, Grant Thornton does not accept any responsibility or assume any liability to any party other than AIUK, AIEU and the Court who chooses to act on the basis of any of my reports.

Professional Guidance

1.40 As an Independent Expert reporting to the Court, I am required to act in accordance with Part 35 of the Civil Procedure Rules, Practice Direction 35 and the Guidance for the Instruction of Experts in Civil Claims. Accordingly, this report is prepared for the assistance of the Court and I confirm that I understand my duty to the Court and have complied with that duty.

1.41 This report has been prepared under the terms of the Statement of Policy produced by the PRA in April 2015, namely "The Prudential Regulation Authority's approach to insurance business transfers" and the guidance set out in Chapter 18 of the Supervision Manual ("SUP18") contained in the FCA Handbook of Rules and Guidance to cover scheme reports on the transfer of insurance business. In addition, this report has been prepared in accordance with the FCA's guidance paper entitled "The FCA's approach to the review of Part VII insurance business transfers".

1.42 In my opinion, this report has been produced in line with the requirements of the Technical Actuarial Standards ("TASs") issued by the Financial Reporting Council ("FRC"). In particular, this report has been prepared in accordance with TAS 100: Principles of Technical Actuarial Work and TAS 200: Insurance.

1.43 This report has also been produced in line with the requirements of APS X3: The Actuary as an Expert in Legal Proceedings, issued by the IFoA.

1.44 In addition, this report has been internally peer reviewed in line with the requirements of APS X2: Review of Actuarial Work, issued by the IFoA.

1.45 I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions that I have expressed and the conclusions that I have drawn represent my true and complete professional opinions on the matters to which they refer.

2 Executive Summary

Overview of the Scheme

2.1 AIUK is permitted to sell and administer general insurance contracts across a range of classes of business in the UK, as well as several other countries throughout the EEA through its EEA Passporting Rights.

2.2 AIUK's EEA Passporting Rights may no longer exist following the current transition period in respect of the UK's withdrawal from the European Union ("Brexit Transition Period"). AIUK is therefore seeking to transfer its insurance business in the EEA to another entity that will have the appropriate permissions to transact this business after the end of the Brexit Transition Period.

2.3 The Scheme will transfer the policies in relation to the Transferring Portfolio from AIUK to AIEU. This means that AIEU will become the insurer of the Transferring Portfolio and will assume responsibility for paying claims to the transferring policyholders.

2.4 AIEU will acquire all of the rights, benefits and powers of AIUK in relation to the Transferring Portfolio.

2.5 The following business will be transferred to AIEU under the Scheme:

- All policies forming part of the portfolio of general insurance policies of AIUK carried out prior to the Effective Date where the risk associated with such policies is written on a Freedom of Services basis or a Freedom of Establishment basis
- The outwards reinsurance policies issued to AIUK where these are relevant to or provide protection for a policy referred to in the previous bullet point
- Contracts and other commitments to which AIUK is a party at the transfer date and which relate to the policies or reinsurance policies referred to above (this will include the coverholder arrangements currently in place in the various EEA States other than the UK in which risks are located)
- The assets and liabilities (excluding misselling liabilities) relating to each of the above.

2.6 The Scheme excludes the following AIUK policies and this business will not transfer to AIEU:

- All policies forming part of the portfolio of general insurance policies of AIUK carried out prior to the Effective Date where the risk associated with such policy is not written on a Freedom of Services basis or a Freedom of Establishment basis other than the UK
- All inwards reinsurance policies

2.7 I understand from AIUK and AIEU that there are currently no policies or reinsurance contracts that will not be transferred to AIEU under the Scheme other than those captured in paragraph 2.6. The Scheme is expected to take effect on the Effective Date. The Scheme will lapse if the Scheme has not become effective on or before 31 December 2020, or a later date agreed by AIUK and AIEU and allowed by the Court.

Background to the parties

AIUK

2.8 AIUK was incorporated in November 2003 as Arch Company (Europe) Limited. AIUK subsequently changed its name to Arch Insurance (Company) Europe Limited in January 2004 and to Arch Insurance (UK) Limited in March 2020. AIUK operates from its head office in London and its other UK regional offices.

2.9 AIUK is a wholly owned subsidiary of Arch Reinsurance Europe Underwriting dac (an Irish company) which itself is wholly owned by Arch Financial Holdings Europe II, and its ultimate parent is Arch Capital

Group Ltd. ("ACGL") a Bermuda exempted company limited by shares. The common shares of ACGL are listed and traded on the NASDAQ Stock Market in the U.S.

2.10 Historically, AIUK has underwritten Energy, Property and Casualty insurance business with a focus on Specialty lines of insurance.

2.11 On 1 January 2019, a sister company, Arch UK Holdings Limited, completed the acquisition of the UK commercial lines business previously owned by the Ardonagh Group. AIUK has entered into a licensing agreement with Arch UK Holdings Limited to renew this acquired business. The acquired business forms the Arch UK Regional Division. It focusses on commercial property, casualty, motor, professional liability, personal accident and travel. I am not aware of any plans by AIUK to change this following the Scheme.

2.12 Until 1 January 2020, AIUK wrote business across a number of EEA states other than the UK, the largest by number of risks being Italy, Spain and Germany. However, I understand from AIUK that from 1 January 2020, AIUK ceased writing non-UK EEA business, other than a small book of 40 policyholders, and all other non-UK EEA policies have since been written by AIEU.

AIEU

2.13 AIEU is an Irish regulated insurance entity authorised by the Central Bank of Ireland ("CBI"). The immediate parent of AIEU is Arch Financial Holdings Europe II Limited and the ultimate parent of AIEU is ACGL.

2.14 It received its license from the CBI in December 2011, as Arch Mortgage Insurance Limited, with authorisation to provide credit insurance. It received an extension of its authorisation from the CBI to include Surety insurance in 2015 and, in October 2015, changed its form to become a designated activity company with the new name Arch Mortgage Insurance dac. In March 2019, it changed its name from Arch Mortgage Insurance dac to Arch Insurance (EU) Designated Activity Company.

2.15 Arch Reinsurance Ltd., the immediate parent of Arch Financial Holdings Europe II Limited, provides the same 85% intercompany quota share reinsurance to AIEU as to AIUK, on AIEU's claims liabilities, with the exception of risks attaching prior to March 2019 for which the percentage ceded is 90%.Until March 2019, AIEU solely wrote mortgage insurance, providing credit insurance to mortgage lenders in relation to borrower non-payments of residential housing loan debt on a Freedom of Services basis in EU Member States.

2.16 In March 2019, AIEU received approval from the CBI and respective Host State supervisors for Freedom of Establishment Branches in the UK, Italy and Denmark. AIEU's UK branch has entered the Temporary Permissions Regime, allowing AIEU to conduct regulated activities in the UK after 31 December 2020 pending an application to the PRA for full authorisation.

2.17 On 6 March 2019, AIEU received authorisation from the CBI to expand its insurance licence, covering all classes of insurance business, except Class 18 'Assistance'. Since then, AIEU has split its business into three divisions: "Mortgage Insurance", "Alwyn Europe" and "P&C". I discuss these three divisions in more detail in paragraphs 5.38 to 5.43 below.

My approach

2.18 My approach to assessing the likely effects of the Scheme on policyholders, co-insurers and reinsurers is to:

- Understand the nature and structure of the Scheme
- Identify the groups of policyholders that would be affected

- Assess the financial positions of the companies involved in the Scheme
- Consider the implications of the Scheme on the level of security provided to the affected policyholders
- Consider the potential impact on levels of customer service
- Consider other financial factors that might affect policyholders
- Consider other non-financial factors that might affect policyholders
- Consider the implications of the Scheme on AIUK's and AIEU's reinsurers
- Consider the implications of the Scheme on AIUK's and AIEU's co-insurers.

2.19 In order to consider the effect of the Scheme on each of the entities and groups of policyholders concerned, I have been provided with a range of published and internal documentation by AIUK and AIEU. A listing of the documents provided to me is shown in Appendix A. Where I have been provided with evidence of legal advice given to any of the Arch entities mentioned throughout this Report, it is not intended to, and does not waive, privilege in relation to any such advice.

2.20 In general, this report is based on data and information at 31 December 2019, being the most recent date at which financial information was available. Where 31 December 2019 data was not available, I have used the most recent data available which may be at an earlier date. There are also instances where I have used more recent information where it was readily available at the time of writing. I will issue a Supplementary Report containing the most up to date information available to me prior to the final Court hearing.

2.21 In forming my opinion, I have spoken with key personnel responsible for core functions in AIUK and AIEU. I have also placed reliance on the information provided to me by AIUK and AIEU.

2.22 I have placed reliance on estimates of the claims reserves in respect of each of AIUK and AIEU. In Section 13, I describe the information that I have relied upon in relation to the reserves of AIUK and AIEU and the analyses I have undertaken to assure myself that it is reasonable to rely on that information.

2.23 Further to this, I have placed reliance on estimates of the regulatory and economic capital requirements in respect of each of AIUK and AIEU. In Section 8, I describe the information that I have relied upon in relation to the capital requirements of AIUK and AIEU and the analyses I have undertaken to assure myself that it is reasonable to rely on that information.

Findings

2.24 The findings in this report are summarised in this section. The detailed explanation behind these conclusions follows in the body of this report.

2.25 I have identified three distinct groups of policyholders who will be impacted by the Scheme:

- The transferring policyholders
- The remaining policyholders
- The existing policyholders.

Policyholder security

2.26 Below, I set out my opinions on policyholder security. Evidence supporting these opinions is discussed in Sections 8 and 9 of this report.

Transferring policyholders

2.27 With respect to the Transferring Portfolio, I do not expect any material adverse impact on policyholder security, including under insolvency, as a result of the Scheme. This is because I consider that AIEU will have a sufficient level of capital in order to meet policyholder obligations following the Scheme.

2.28 Please note that this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

Remaining policyholders

2.29 With respect to the remaining AIUK policyholders, I do not consider that there will be any material adverse impact on policyholder security, including under insolvency, as a result of the Scheme. This is because I consider that AIUK will have a sufficient level of capital in order to meet policyholder obligations following the Scheme.

Existing policyholders

2.30 With respect to the existing AIEU policyholders I do not expect any material adverse impact on policyholder security, including under insolvency, as a result of the Scheme. This is because I consider that AIEU will have a sufficient level of capital in order to meet policyholder obligations following the Scheme.

2.31 Please note this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

Levels of service

2.32 I do not anticipate any material changes to the level of service provided to any of the groups of policyholders following the Scheme.

Other financial and non-financial considerations

2.33 I do not expect any material adverse impact to any group of policyholders following the Scheme as a result of the other financial and non-financial factors that I have considered.

2.34 The other financial factors that I have considered are:

- Financial impact of COVID-19
- Investment strategy
- Liquidity position
- Implications of the Scheme on ongoing expense levels
- Pension arrangements
- Tax implications
- Impact of other transfers

2.35 The other non-financial factors that I have considered are:

- Regulatory regime
- Complaints
- Claims handling and policy administration
- Recognition of the Scheme in other jurisdictions
- Governance and management frameworks
- Impact of the EU referendum

- Ruling of Mr Justice Snowden on the proposed Part VII transfer of a book of in-payment annuities from The Prudential Assurance Company Limited to Rothesay Life Plc
- Non-financial impact of COVID-19
- The impact on policyholders should the Scheme not become effective.

2.36 I have also considered the strategy for notifying impacted policyholders and reinsurers about the Scheme.

Impact on transferring reinsurers

2.37 I identify no reinsurers transferring from AIUK to AIEU that would be materially adversely affected by the Scheme.

Impact on existing co-insurers

2.38 I identify no co-insurers transferring from AIUK to AIEU that would be materially adversely affected by the Scheme.

Conclusion

2.39 I conclude that I do not consider that the Scheme will result in material detriment to any policyholders, reinsurers or co-insurers affected by the Scheme, relative to their current situation and therefore, I see no reason why the Scheme should not proceed.

2.40 Please note that this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

3 Scope

Purpose of this report

3.1 I am required as the Independent Expert to consider the likely effects of the Scheme on policyholders, including whether or not the Scheme will result in material detriment to any policyholders affected by the Scheme, relative to their current situation. The purpose of this report is to set out my considerations. For the purposes of this report, policyholders include existing and future claimants.

Policyholders affected by the Scheme

3.2 This report considers the effect of the Scheme on the following groups of policyholders:

- The policyholders transferring from AIUK to AIEU under the Scheme
- The policyholders remaining within AIUK following the Scheme
- The existing policyholders of AIEU.

3.3 I have not considered the impact of the Scheme on any policyholders that subsequently effect policies with either AIUK or AIEU.

What is a material detriment to policyholders?

3.4 Material detriment in the context of this report means any material adverse effect on:

- The security of policyholders' contractual rights
- The levels of service provided to policyholders.

3.5 For the purposes of this report, a material adverse effect is defined as a negative change that is considered to have a material impact on policyholders. A material impact is one that could cause a policyholder to take a different view on the future performance of their policy.

3.6 When considering policyholder security, this would be the case if the Scheme would result in a substantially greater probability of a policyholder's claim not being paid, in comparison to the probability of a policyholder's claim not being paid due to day-to-day fluctuations in the value of assets in the company's investment portfolio, or from the reporting of a particularly large but not extreme claim.

3.7 In terms of non-financial impacts, an assessment of materiality is more subjective but, as an example, a change in the claims handling process that added a few hours to the customer response time is probably not material. However, if it added a few days then it could be, depending on the type of claim.

Reinsurers affected by the Scheme

3.8 I have considered the impact of the Scheme on any reinsurers that provide protection to the Transferring Portfolio and will continue to provide protection to the Transferring Portfolio following the Scheme. A material adverse impact on a reinsurer is one that could cause the reinsurer to take a different view on the future performance of the reinsurance policy that it has written. A hypothetical example could be that the Scheme gives rise to a non-trivial additional exposure for the reinsurer.

Co-insurers affected by the Scheme

3.9 I have considered the impact of the Scheme on any co-insurers that provide protection to the Transferring Portfolio and will continue to provide protection to the Transferring Portfolio following the Scheme. A material adverse impact on a co-insurer is one that could cause the co-insurer to take a different view on the future performance of the policy that it has co-insured. A hypothetical example could be that the Scheme gives rise to a non-trivial additional exposure for the co-insurer.

Alternative schemes or proposals considered

3.10 I have considered the terms of the Schemes only and have not considered whether any other scheme or schemes or alternative arrangement might provide a more efficient or effective outcome.

Future changes of ownership

3.11 I have not considered any future changes of ownership in either AIUK or AIEU. I am not aware of any proposals to change ownership at the time of writing this report.

Currency

3.12 The figures used throughout this report are shown in Pound Sterling unless stated otherwise.

3.13 Where I have converted currencies, I have used the following exchange rates which are the 31 December 2019 exchange from the Bank of England website:

- 1 US Dollar = 0.757 Pound Sterling
- 1 Euro = 0.850 Pound Sterling

Reliance on data

3.14 A list of the data provided to me can be found in Appendix A.

3.15 I have neither audited nor have I independently verified the data and information supplied to me. However, I have reviewed it for reasonableness and for internal consistency.

3.16 I have checked that all of the information I have been provided with has been supplied by persons appropriately qualified to provide such information, in particular, I have reviewed the CVs of the individuals who are responsible for the analysis underlying the information provided to me. Having done so, I am satisfied that it is reasonable for me to rely on this information.

3.17 I have been provided with all the information that I have requested.

Peer review process

3.18 In accordance with the IFoA's Guidance APS X2 on the Review of Actuarial Work and the internal control processes of Grant Thornton, the work documented in this report has been peer reviewed by a suitably qualified person (an actuary within Grant Thornton who has considerable experience of Part VII transfers and of working in capital modelling and reserving in the general insurance market). The peer review process has included a review of the methodology and key assumptions used and discussion of the key elements of the analysis.

Supplementary Report

3.19 Shortly before the date of the final Court hearing at which an order sanctioning the Scheme will be sought, I will prepare a Supplementary Report covering any relevant matters which might have arisen since the date of this report.

4 Methodology

4.1 In this section, I describe my approach to assessing the Scheme.

4.2 My conclusions have been drawn by undertaking the following activities:

- Reviews of documentation received from AIUK and AIEU
- Discussions with key personnel at AIUK and AIEU
- Undertaking my own analysis, where necessary.

4.3 In particular:

- My view on the insurance liabilities of the Transferring Portfolio is based upon my review of the calculations and documentation provided to me by AIUK and AIEU, and discussions with the relevant individuals at AIUK and AIEU
- My view on the insurance liabilities of AIUK is based upon my review of documentation provided to me by AIUK, and discussions with the relevant individuals at AIUK
- My view on the insurance liabilities of AIEU is based upon my review of documentation provided to me by AIEU, and discussions with the relevant individuals at AIEU
- My view on the capital requirements and assessments of AIUK is based upon my review of the outputs and documentation provided to me by AIUK, and discussions with the relevant individuals at AIUK
- My view on the capital requirements and assessments of AIEU is based upon my review of the outputs and documentation provided to me by AIEU, and discussions with the relevant individuals at AIEU.

4.4 My approach to assessing the Scheme has been to:

- Understand the nature and structure of the Scheme and identify the groups of policyholders that will be affected
- Assess the financial positions of AIUK and AIEU
- Consider the implications of the Scheme for the level of security, including under insolvency, being offered to each group of policyholders
- Consider the potential impact on levels of customer service
- Consider other factors that might affect policyholders
- Consider the implications of the Scheme for the reinsurers of the Transferring Portfolio
- Consider the implications of the Scheme for the co-insurers of the Transferring Portfolio.

4.5 I provide additional details of each of the activities listed in paragraph 4.4 in the remainder of this section.

Understand the nature and structure of the Scheme and identify the groups of policyholders that would be affected

4.6 I have discussed the nature and the structure of the Scheme with AIUK and AIEU and reviewed relevant documentation that I have received.

Assess the financial positions of AIUK and AIEU

4.7 The level of security provided to policyholders of an insurance company depends on the available capital of the company and, in particular, the probability that this level of capital is sufficient to make claim payments as they fall due.

Assess the financial strengths of AIUK and AIEU

4.8 I have considered the balance sheets of AIUK and AIEU on an accounting basis and on a regulatory basis as part of my assessment of their relative financial strengths, including the net assets and levels of capital.

4.9 I have compared the balance sheets of AIUK and AIEU prior to the Scheme with the balance sheets following the Scheme based on data at 31 December 2019, being the most recent date at which financial information was available.

4.10 The financial strengths of AIUK and AIEU are discussed in Sections 7, 8 and 9, of this report.

Assess the claims reserves of AIUK and AIEU

4.11 An important part of the security provided to policyholders is the strength of the claims reserves – the amount of money the insurer puts aside to pay out on unpaid reported claims, unreported claims and future claims in respect of policies already sold. The claims reserves generally form the largest part of the liabilities for a general insurer.

4.12 I have therefore considered the claims reserves included on the balance sheet for each of AIUK and AIEU. I have also considered the technical provisions on a Solvency II basis for each of AIUK and AIEU. This is discussed in Section 7.

Assess the capital positions of AIUK and AIEU

4.13 My assessment of the capital positions of AIUK and AIEU is discussed in Sections 8 and 9.

Regulatory capital requirements

4.14 Insurers are subject to capital requirements imposed by regulators. This is the PRA in the case of AIUK and the CBI in the case of AIEU. These capital requirements are discussed in more detail in Section 6. The level of available capital compared to regulatory capital requirements is a measure of the security provided to the policyholders.

4.15 To further review the financial strength of AIUK and AIEU, I have reviewed the modelling undertaken by each insurer to assess the required regulatory capital.

4.16 I have also compared the coverage of the regulatory capital requirements prior to the Scheme with the coverage of the regulatory capital requirements following the Scheme for both AIUK and AIEU based on projections to 31 December 2020, the Effective Date of the Scheme. Details of this comparison are discussed in Section 9.

Own assessment of required capital

4.17 Insurers are also required to undertake an assessment of their own risks and solvency needs and hence their view of the required capital. Another measure of the security provided to policyholders is the level of available capital compared to the insurer’s view of required capital (also known as its “economic capital requirement”).

4.18 I have reviewed the modelling undertaken by each insurer to assess its own view of its required capital.

Stress testing

4.19 In addition, I have undertaken my own testing to understand the robustness of the capital bases of AIUK and AIEU to various stresses.

Consider the implications of the Scheme for the level of security, including under insolvency, being offered to each group of policyholders

4.20 I have considered each group of policyholders, both before and after the Scheme, and the relative level of security available to them, including under insolvency. This is discussed further in Section 9.

Consider the potential impact on levels of customer service

4.21 I have considered how the level of customer service, specifically claims handling and policy servicing, experienced by each group of policyholders could change following the Scheme. This is discussed in paragraphs 11.13 to 11.20.

Consider other financial factors that might affect policyholders

4.22 Through my discussions with AIUK and AIEU and reviews of documentation, I have also considered various other financial factors that might affect policyholders, namely the following:

- Financial impact of COVID-19
- Investment strategy
- Liquidity position
- Implications of the Scheme on ongoing expense levels
- Pension arrangements
- Tax implications
- Impact of new business strategy
- Impact of other transfers.

4.23 These issues are discussed in Section 10.

Consider other non-financial factors that might affect policyholders

4.24 Through my discussions with AIUK and AIEU and reviews of documentation, I have also considered various other non-financial factors that might affect policyholders, namely the following:

- Regulatory jurisdiction
- Claims handling and policy administration
- Complaints
- The recognition of the Scheme in other jurisdictions
- Governance and management frameworks
- ‘Brexit’
- Ruling of Mr Justice Snowden on the proposed Part VII transfer of a book of in-payment annuities from The Prudential Assurance Company Limited to Rothesay Life Plc
- Non-financial impact of COVID-19

- The impact on policyholders should the Scheme not become effective.

4.25 These issues are discussed in Section 11.

Consider the implications of the Scheme for existing co-insurers

4.26 I have considered the implications of the Scheme on any co-insurers transferring as a result of the Scheme. This is discussed in paragraphs 10.52 to 10.53.

Consider the implications of the Scheme for transferring reinsurers

4.27 I have considered the implications of the Scheme on any reinsurers transferring as a result of the Scheme. This is discussed in paragraphs 10.54 to 10.58.

Consider the communication strategy

4.28 Through my discussions with AIUK and AIEU and reviews of documentation, I have also considered the communication strategy that they are planning to use to notify impacted policyholders, co-insurers and reinsurers about the Scheme.

4.29 These issues are discussed in Section 12.

5 Background

Background to AIUK

5.1 AIUK was incorporated in November 2003 as Arch Company (Europe) Limited. AIUK subsequently changed its name to Arch Insurance (Company) Europe Limited in January 2004 and to Arch Insurance (UK) Limited in March 2020. AIUK operates from its head office in London and its UK regional offices.

5.2 AIUK is a wholly owned subsidiary of Arch Reinsurance Europe Underwriting dac (an Irish company) and its ultimate parent is Arch Capital Group Ltd. ("ACGL") a Bermuda exempted company limited by shares. The common shares of ACGL are listed and traded on the NASDAQ Stock Market in the U.S.

5.3 AIUK is authorised by the PRA and regulated by both the PRA and the FCA. Under its current authorisations, AIUK is permitted to sell and administer general insurance contracts across a range of classes of business in the UK as well as several other countries throughout the EEA through its EEA Passporting Rights.

5.4 At the time of writing this report, AIUK has a credit rating from Standard & Poor's of A+.

5.5 At 31 December 2019, AIUK had £639.0m of gross insurance provisions and £80.3m of net assets on its GAAP balance sheet as per its published Annual Report and Financial Statements.

Arch Capital Group Limited ("ACGL")

5.6 The immediate parent of AIUK is Arch Reinsurance Europe Underwriting dac, which itself is wholly owned by Arch Financial Holdings Europe II Limited. The ultimate parent of AIUK is Arch Capital Group Limited ("ACGL") which, together with its subsidiaries, forms the "Arch Group" whose common shares are listed and traded on the NASDAQ Stock Market in the U.S.

AIUK's insurance business

5.7 Historically, AIUK has underwritten Energy, Property and Casualty insurance business with a focus on Specialty lines of insurance.

5.8 On 1 January 2019, a sister company, Arch UK Holdings Limited, completed the acquisition of the UK commercial lines business previously owned by the Ardonagh Group. AIUK has entered into a licensing agreement with Arch UK Holdings Limited to renew this acquired business. The acquired business forms the Arch UK Regional Division. It focusses on commercial property, casualty, motor, professional liability, personal accident and travel. I am not aware of any plans by AIUK to change this following the Scheme.

5.9 Until 1 January 2020 AIUK wrote business across a number of EEA states, the largest by number of risks being Italy, Germany and Spain. However, I understand from AIUK that from 1 January 2020, AIUK ceased writing non-UK EEA business, other than a small book of 40 policyholders, and that all other non-UK EEA policies have since been written by AIEU.

5.10 The 40 EEA policies above that were underwritten by AIUK after 1 January 2020 comprise of marine insurance policies and are domiciled in the Netherlands.

The Remaining Portfolio

5.11 The majority (72.2%) of the 163,976 policies in the Remaining Portfolio as at 31 December 2019 relate to the following lines of business:

- Professional Indemnity business written via AIUK's largest coverholder (36.2%)
- Executive Assurance business written via AIUK's largest coverholder (28.4%)
- Professional Liability for Small-Medium Enterprises (7.6%).

5.12 The remaining 27.8% of policies in the Remaining Portfolio are spread across a range of lines of business, none of which individually comprise more than 5.4% of policies.

5.13 Of the 3,685 open claims within the Remaining Portfolio as at 31 December 2019, the majority (80.0%) are split across the following lines of business:

- Professional Liability for Small-Medium Enterprises (18.3%)
- Professional Indemnity business written via AIUK's largest coverholder (18.2%)
- Executive Assurance business written via AIUK's largest coverholder (13.5%)
- Professional Liability (Large and Complex) (13.0%)
- Offshore Energy (9.4%)
- Onshore Energy (7.6%)

5.14 The remaining 20.0% of open claims in the Remaining Portfolio are spread across a range of lines of business, none of which comprise more than 5% of open claims for the Remaining Portfolio.

Intercompany Quota Share and Stop Loss reinsurance arrangements

5.15 Arch Reinsurance Ltd., the immediate parent of Arch Financial Holdings Europe II Limited, provides an 85% intercompany quota share reinsurance to AIUK on AIUK's claims liabilities ("IQS"), after recoveries from other reinsurers. Arch Reinsurance Ltd. was formed in 2001 and operates from its offices in Bermuda. As well as providing reinsurance to AIUK it also provides reinsurance to AIEU and to external insurers.

5.16 I understand that the primary purpose of the IQS is to support AIUK in maintaining its credit rating of A+. In addition to this, the IQS also mitigates the credit risk arising from external reinsurance arrangements since, in the case of a reinsurer defaulting, the IQS will absorb 85% of the associated loss.

5.17 AIUK also uses Stop Loss reinsurance to provide coverage above a loss ratio of 110%, with a maximum of $25m recoverable. This is an internal reinsurance arrangement between AIUK and Arch Reinsurance Ltd., covering all lines of business written by AIUK.

5.18 I have been informed by AIUK that the Stop Loss reinsurance has never been triggered since it was purchased during the formation of AIUK, (which was called Arch Insurance Company (Europe) at the time).

Pension scheme obligations

5.19 AIUK has informed me that it does not maintain any defined benefit retirement or pension plans. However, it contributes to a defined contribution Group pension plan scheme. The assets of this pension scheme are held separately from AIUK's own assets in an independently administered fund.

5.20 I have been informed by AIUK that there are no pension scheme obligations to be considered in this transfer.

The Transferring Portfolio

5.21 The Transferring Portfolio consists of those policies within the portfolio of general insurance policies of AIUK carried out prior to the date of transfer where the risk associated with the policy is written on a Freedom of Services basis or a Freedom of Establishment basis.

5.22 These policies are currently all insured by AIUK, with business being underwritten since 2004. As I discussed in paragraph 5.9, the Transferring Portfolio pertains to AIUK policies written before 1 January 2020 and to the 40 EEA policyholders underwritten by AIUK after 1 January 2020 which I discussed in paragraphs 1.10, 2.12 and 5.9. The remainder of AIUK's policies will form the Remaining Portfolio. Non-UK EEA policies written after 1 January 2020 which would have historically been written by AIUK (apart from those discussed in paragraphs 1.10, 2.12 and 5.9) have since been written AIEU.

The transferring policyholders

5.23 Nearly all (97.2%) of the 458,000 policies in the Transferring Portfolio as at 31 December 2019 relate to the following lines of business:

- Professional Indemnity business written via AIUK's largest coverholder (84.2%)
- Executive Assurance business written via AIUK's largest coverholder (13.1%)

5.24 The remaining 2.8% of policies in the Transferring Portfolio are spread across a range of lines of business as shown below:

- Executive Assurance (1.3%)
- Energy (0.5%)
- Personal Accident and Travel (0.3%)
- Professional Indemnity (0.2%)
- Marine (0.2%)
- General Liability (0.2%)
- International Property and Property Binders (0.1%)
- Political Risk and Terrorism (0.1%)

Liabilities within the Transferring Portfolio

5.25 Of the 9,504 open claims within the Transferring Portfolio as at 31 December 2019, nearly all (90.9%) are split across the following lines of business:

- Professional Indemnity business written via AIUK's largest coverholder (81.8%)
- Executive Assurance business written via AIUK's largest coverholder (9.2%)

5.26 The remaining 9.1% of open claims in the Transferring Portfolio are spread across a range of lines of business, none of which comprise more than 1% of open claims in the Transferring Portfolio.

5.27 Nearly all (98.8%) of the transferring policies are written via coverholder arrangements, of which 97.3% are written by various EEA entities of AIUK's largest coverholder, the largest being the Italian entity which has written 71.2% of the total policies within the Transferring Portfolio. Other EEA entities of AIUK's largest coverholder which have written business in the Transferring Portfolio include the German and Spanish entities.

5.28 As at 31 December 2019, 449,489 (98.1%) of policies in the Transferring Portfolio were written on a Claims Made basis, all of which will expire by 31 December 2020 with the exception of 19 construction policies.

5.29 As at 31 December 2019, 6,756 (1.5%) of the transferring policies were written on a Losses Occurring During ("LoD") basis, which equates to 20.7% (£213.0m) of the GWP within the Transferring Portfolio. These policies were written between 2009 and 2014.

5.30 AIUK has been unable to determine the nature of the remaining 1,853 (0.4%) policies. Therefore, with the exception of the 19 construction policies mentioned in paragraph 5.28and the 1,853 unknown-basis policies, all of the unexpired policies within the Transferring Portfolio on the Effective Date will have been written on an LoD basis .

5.31 As at 31 December 2019, AIUK had a total GWP of £3.7bn and the Transferring Portfolio accounted for £1.1bn of this.

Background to AIEU

5.32 AIEU is an Irish regulated insurance entity authorised by the Central Bank of Ireland ("CBI").

5.33 It received its license from the CBI in December 2011, as Arch Mortgage Insurance Limited, with authorisation to provide credit insurance. It received an extension of its authorisation from the CBI to include Surety insurance in 2015 and, in October 2015, changed its form to become a designated activity company with the new name Arch Mortgage Insurance dac. In March 2019, it changed its name from Arch Mortgage Insurance dac to Arch Insurance (EU) Designated Activity Company.

5.34 The immediate parent of AIEU is Arch Financial Holdings Europe II Limited and the ultimate parent of AIEU is ACGL.

5.35 Until March 2019, AIEU solely wrote mortgage insurance, providing credit insurance to mortgage lenders in relation to borrower non-payments of residential housing loan debt on a Freedom of Services basis in EU Member States.

5.36 In March 2019, AIEU received approval from the CBI and respective Host State supervisors for Freedom of Establishment Branches in the UK, Italy and Denmark. On 6 March 2019, AIEU received authorisation from the CBI to expand its insurance licence, covering all classes of insurance business, except Class 18 'Assistance'. Since then, AIEU has split its business into three divisions: "Mortgage Insurance", "Alwyn Europe" and "P&C". I discuss these three divisions in more detail in paragraphs 5.38 to 5.43 below.

5.37 In 2019, AIEU's GWP was £85.1m. I understand from AIEU that this amount is expected to increase in 2020 which will include a full 12 months of business written by the Alwyn Europe and P&C divisions which began writing business in March 2019.

AIEU's insurance business

Alwyn Europe Division

5.38 As at 31 December 2019, AIEU's Alwyn Europe Division accounted for 57.1% of its written business, comprising of motor and pet insurance business in the Irish market. This business is written via five Ireland-based Managing General Agents ("MGAs").

P&C Division

5.39 As at 31 December 2019, the P&C Division accounted for 34.9% of AIEU's business. The P&C Division is classified into two underwriting units, comprising of:

- Financial Lines, Property and Casualty
- Specialty (including Accident & Health, Terrorism, and Credit and Political Risk), Energy (Onshore and Offshore) and Marine.

5.40 As I discussed in paragraph 5.9, from 1 January 2020, AIUK ceased writing non-UK EEA business, other than a small book of 40 policyholders, and all other non-UK EEA policies have since been written by AIEU in its P&C Division.

5.41 A significant amount of Financial Lines business is written through MGA relationships. 43.3% of all planned written premium within the P&C Division in 2020 is in respect of a single Italian branch of a global coverholder group.

Mortgage Insurance Division

5.42 As at 31 December 2019 the remaining 8.9% of AIEU's business lies within its Mortgage Division, which I discussed in paragraph 5.35.

5.43 Business written within AIEU's Mortgage Insurance Division can be written on a "flow basis" or "portfolio basis":

- For the flow basis, AIEU has a master insurance contract with a lender which allows for cover to be provided for eligible newly originated mortgage loans originated in a future specified time period. Premium payment terms on flow business are typically a single payment at the commencement of the cover period.
- For the portfolio basis, cover is provided in respect of a cohort of existing originated mortgage loans. Premium payment terms on portfolio business are typically recurring quarterly payments during the coverage period.

Intercompany Quota Share and Stop Loss reinsurance arrangements

5.44 Arch Reinsurance Ltd., the immediate parent of Arch Financial Holdings Europe II Limited, also provides an 85% intercompany quota share reinsurance to AIEU on AIEU's claims liabilities, the coverage of which is analogous to that I discussed for AIUK in paragraphs 5.15 to 5.18, with the exception of risks attaching prior to March 2019 for which the percentage ceded is 90%.

Arch Europe Insurance Services Ltd. ("AEIS")

5.45 Currently, AEIS employs all staff which provide services to support AIUK's operations. I understand that AIEU has obtained permission from the CBI use the services provided by AEIS, and that AEIS currently supports AIEU's P&C Division and will continue to support the Transferring Portfolio following the Scheme.

5.46 Therefore, following the Effective Date, the same AEIS UK staff will continue to service policies in the Transferring Portfolio on the same terms as the service and secondment arrangements already in place.

Pension scheme obligations

5.47 I have been informed by AIEU that there are no pension scheme obligations to be considered in this transfer.

Overview of the Scheme

Purpose of the Scheme

5.48 Under its current authorisations, AIUK is permitted to sell and administer general insurance contracts across a range of classes of business in the EEA through its EEA Passporting Rights.

5.49 AIUK's EEA Passporting Rights may no longer exist following the Brexit Transition Period. AIUK is therefore seeking to transfer its insurance business in the EEA (apart from that in the UK) to another entity that will have the appropriate permissions to transact this business after the end of the Brexit Transition Period.

5.50 The purpose of the Scheme is to transfer the legal obligations relating to the Transferring Portfolio from AIUK to AIEU, while retaining the transferring business within the Arch Group.

Summary of the Scheme

5.51 The Scheme will transfer the policies in relation to the Transferring Portfolio from AIUK to AIEU. This means that AIEU will become the insurer of the Transferring Portfolio and will assume responsibility for paying claims to the transferring policyholders.

5.52 AIEU will acquire all of the rights, benefits and powers of AIUK in relation to the Transferring Portfolio.

5.53 The transferring policyholders will be entitled to the same rights against AIEU in respect of their policies as they currently have against AIUK. In addition, there are no amendments to policy terms and conditions as a result of the Scheme.

5.54 Outwards reinsurance in relation to the Transferring Portfolio which was entered into by AIUK on or before the Effective Date will transfer to AIEU. The agreements will be between AIEU and the reinsurers following the Scheme.

5.55 Any contracts or other commitments to which AIUK is a party at the transfer date and which relate to the policies referred to in paragraph 5.21 or the reinsurance policies referred to in paragraph 5.54, including the coverholder arrangements currently in place in the various EEA States in which risks are located, are to be transferred from AIUK to AIEU as a result of the Scheme.

5.56 Any assets or liabilities related to any of the items in paragraphs 5.21, 5.54 or 5.55 shall also be part of the Transferring Business.

5.57 The Scheme is expected to take effect on the Effective Date. The Scheme will lapse if the Scheme has not become effective on or before 31 December 2020, or a later date agreed by AIUK and AIEU and allowed by the Court.

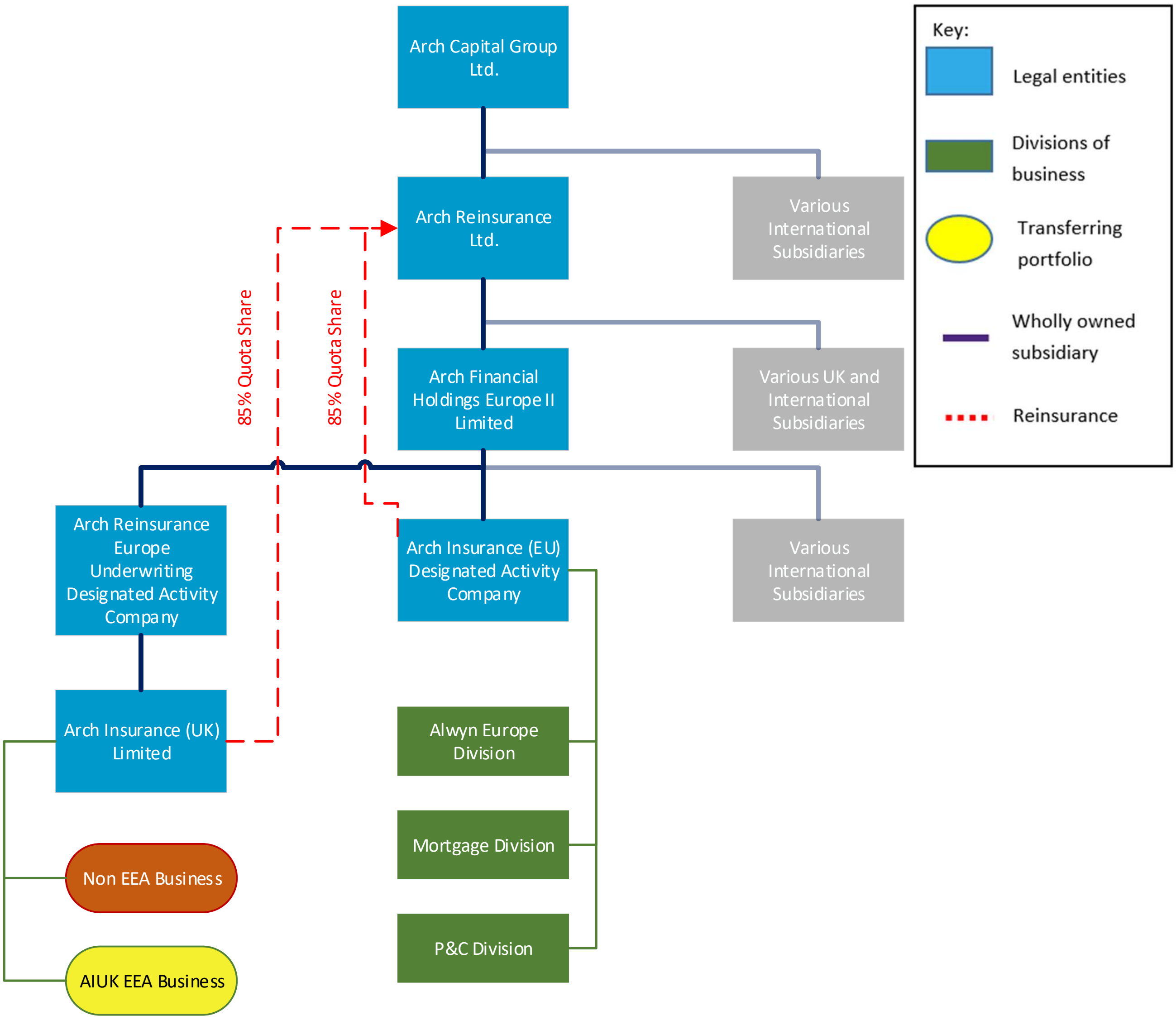
Pension scheme obligations

5.58 It is not intended that AIEU will take on any extra pension liabilities as a result of the Scheme. Liabilities under the AIUK group pension scheme will not transfer to AIEU as a result of the Scheme.

Overview of structure prior to the Scheme

5.59 The diagram below illustrates the structure of the businesses prior to the Scheme.

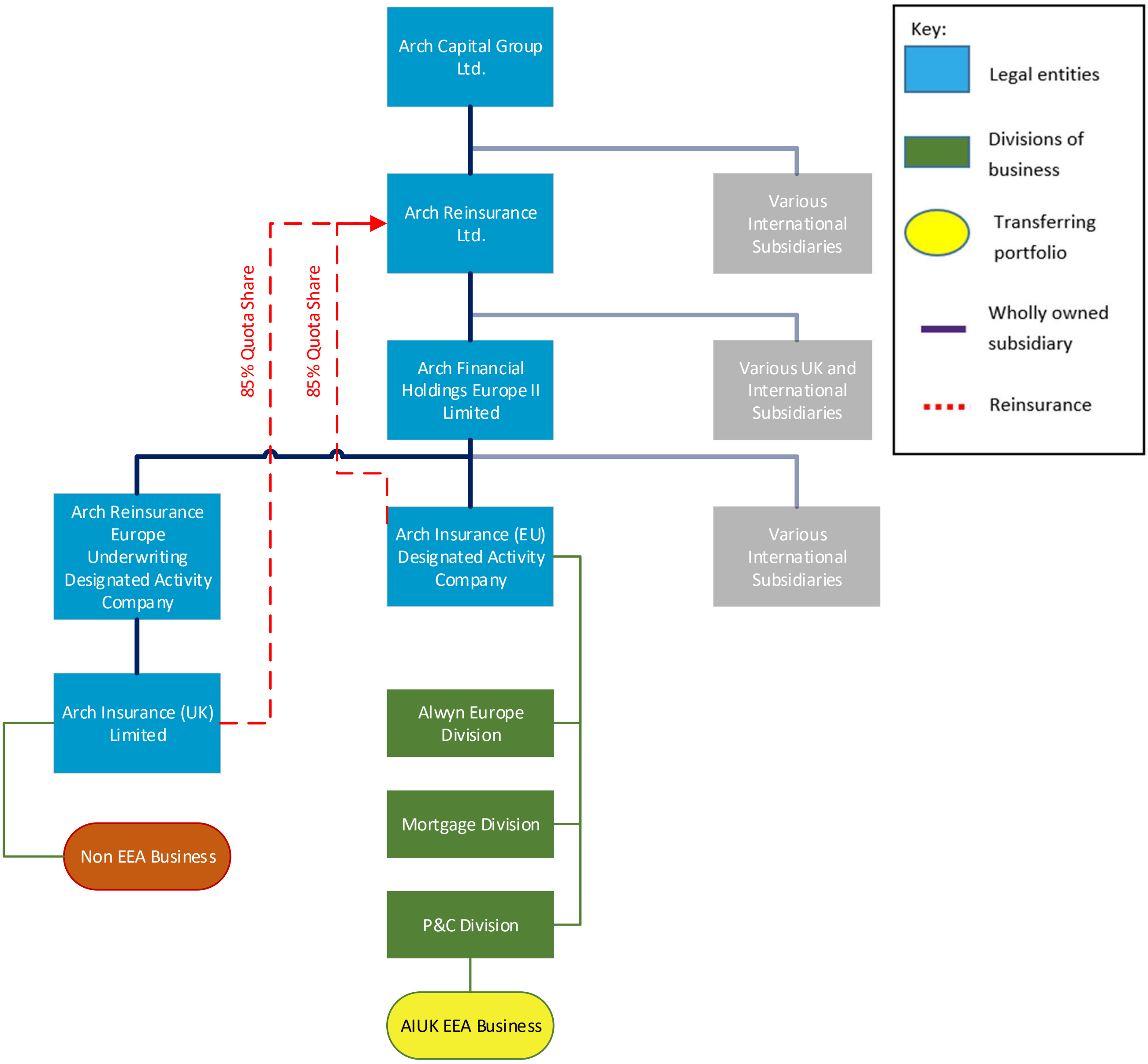
Figure 1: Simplified structure of businesses prior to the Scheme (showing relevant entities only)



Overview of structure following the Scheme

5.60 The diagram below illustrates the structure of the businesses following the Scheme.

Figure 2: Simplified structure of businesses following the Scheme (showing relevant entities only)



6 Regulatory background

6.1 In this section, I provide some background on the regulatory requirements in the UK and Ireland. As discussed in paragraph 14.11, the opinions contained in this report are based on my own analysis and not based on regulators' views of the companies involved.

6.2 This section is structured as follows:

- Paragraphs 6.3 to 6.15 to discuss the prudential regime that applies to all European insurers
- Paragraphs 6.16 to 6.19 discuss the impact of the UK leaving the European Union ("Brexit")
- Paragraphs 6.20 to 6.36 discuss the regulatory environment for insurers authorised in the UK.
- Paragraphs 6.37 to 6.51 discuss the regulatory environment for insurers authorised in Ireland.

Solvency II

6.3 In 2016, insurance regulation in Europe underwent a major overhaul. Since 1 January 2016, all EU insurers have been required to meet a common set of requirements developed by the European Commission ("Solvency II").

6.4 Solvency II is a principles-based regime set around three pillars:

- Pillar 1 – quantitative requirements
- Pillar 2 – qualitative requirements
- Pillar 3 – reporting and disclosure requirements.

Regulatory capital requirements

6.5 Under Solvency II, there are two sets of capital requirements to allow for different levels of supervisory intervention.

6.6 Usually, the higher of these two is the Solvency Capital Requirement ("SCR"). This is the amount of capital required in excess of liabilities in order to ensure continued solvency over a one-year time frame in 99.5% of cases.

6.7 The Minimum Capital Requirement ("MCR") defines the point of most severe supervisory intervention.

Approaches to calculating the SCR

6.8 The SCR can be calculated using one of four approaches: the Standard Formula, the Standard Formula with undertaking specific parameters, an Internal Model, or a Partial Internal Model:

- the Standard Formula approach uses a prescribed set of formulae and parameters in order to work out the SCR.
- within the Standard Formula framework, entities are able to use undertaking specific parameters ("USPs") in order to refine certain parameters, subject to regulatory approval.
- the Internal Model approach involves the entity using its own capital model to calculate the SCR. The model requires regulatory approval.
- the Partial Internal Model approach is a combination of the first and third approaches. An approved Internal Model is used to calculate parts of the SCR and the Standard Formula is used to calculate the remaining parts of the SCR.

6.9 Regardless of the approach used, the calculation of the SCR is designed to capture the nature of the risks within the regulated entity including market related investment risk, insurance risk arising from new business or existing liabilities, and other business risks including credit risk and operational risk.

Solvency II technical provisions

6.10 The technical provisions are the Solvency II equivalent of the claims and premium liabilities on the UK and/or Irish GAAP balance sheet. Under Solvency II, the technical provisions are made up of a claims provision and a premium provision (together the "best estimate technical provisions") and a risk margin. These are defined as follows:

- The claims provision is the discounted best estimate of all future cash flows (claim payments, expenses and future premiums) relating to past exposure
- The premium provision is the discounted best estimate of all future cash flows (claim payments, expenses and future premiums) relating to future exposure arising from policies that the (re)insurer has already written or is obligated to write at the valuation date
- Under Solvency II, insurers must hold a risk margin in excess of their best estimate of liabilities. This risk margin is designed to represent the amount of capital a third party would require to take on the obligations of the insurance company. It effectively means that if an insurer were, as a result of a shock, to use up all its free surplus and capital, then it would still have sufficient assets to safely wind-up and transfer its obligations to a third party.

6.11 It is common to calculate the Solvency II technical provisions by applying a series of adjustments to the UK and/or Irish GAAP or IFRS claims reserves including the following:

- The release of any margins for prudence, as the Solvency II technical provisions assume no margins over best estimate
- The release of the Unearned Premium Reserves ("UPR") and replacement with a provision for expected future claims and expenses on incepted business
- A provision for inflows and outflows relating to legally obliged but unincepted business
- A provision for the expenses that are expected to be incurred to run-off incepted business and legally obligated but unincepted business
- A provision for Events Not in Data ("ENIDs")
- An allowance for discounting to account for the time value of money, calculated using the risk-free yield curves published by the European Insurance and Occupational Pensions Authority ("EIOPA") at the relevant date
- The inclusion of a risk margin, which is calculated as the net present value of the cost of capital associated with insurance and unavoidable market risk.

Own Funds

6.12 Further to calculating the regulatory capital requirements, insurers are required to calculate the level of capital ("Available Own Funds") available to meet the SCR. This requires the calculation of a balance sheet according to Solvency II requirements.

6.13 The Available Own Funds are then assessed and allocated into three tiers based on their permanence and loss absorbency (Tier 1 being the highest quality). The Solvency II regulations impose restrictions on the amount of Tier 2 and Tier 3 Own Funds that can be held to cover the regulatory capital requirements with the aim of ensuring that the capital held to meet the regulatory capital requirements is of sufficient quantity, quality and liquidity to be available, if needed, to meet losses that might arise over the next 12 months. The items which are eligible to meet the SCR are the “Eligible Own Funds” or simply “Own Funds”.

6.14 It is important to note that, even if an insurer does not have sufficient Own Funds to meet its SCR, or even its MCR, then this does not necessarily mean that it would not be able to settle all of its claims in full.

Own Risk and Solvency Assessment

6.15 An additional requirement for Solvency II is that every insurer must undertake an Own Risk and Solvency Assessment ("ORSA") at least annually. This sets out its current and future risk profile and the level of capital that it expects to require over the medium to long term (standard market practice is to consider the next three to five years). It should be noted that this is the insurer’s assessment of the level of capital it requires, not the regulatory capital requirement. It is often referred to as its “economic capital requirement”.

Impact of Brexit

6.16 The UK withdrew its membership from the EU on 31 January 2020 and it is no longer a member of the EU. Following the withdrawal, the UK entered into a transition period during which EU rules and permissions will continue to apply in the UK, despite it no longer being a member of the EU. The transition period is currently expected to end on 31 December 2020.

6.17 To ensure legal continuity in the UK following its departure from the EU, the UK Parliament approved the transposition of EU laws into UK law. However, over time, the UK government will be able to adapt and remove retained EU laws and regulations that are no longer considered to be relevant or appropriate.

6.18 The developments in the insurance regulatory regime in the UK will ultimately be determined by the PRA, the FCA and UK lawmakers. However, what will happen and when it may happen are not yet known.

6.19 This issue is discussed further in paragraphs 11.54 to 11.61.

Overview of UK regulations

6.20 UK insurers are regulated by both the PRA and FCA. The PRA and FCA are statutory bodies set up under the Financial Services Act 2012. Prior to 1 April 2013, all regulation of financial services institutions was undertaken by the Financial Services Authority ("FSA"). All regulatory responsibility was transferred from the FSA to the PRA and/or FCA on 1 April 2013.

6.21 The PRA is part of the Bank of England and is responsible for the prudential regulation of:

- banks
- building societies
- credit unions
- insurance companies
- major investment firms.

6.22 Its three statutory objectives, as applicable to insurance companies, are:

- to promote the safety and soundness of the firms which it regulates
- to contribute to the securing of an appropriate degree of protection for insurance policyholders
- to facilitate effective competition.

The third objective above is secondary to the first two.

6.23 The FCA is a separate organisation and its strategic objective is to ensure that the relevant markets function well.

6.24 To support this, it has three operational objectives:

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

6.25 The FCA has set out its Principles for Businesses, the general statements of the fundamental obligations of firms under its regulatory system. These principles include the following that relate to the fair treatment of customers:

- Principle 6: A firm must pay due regard to the interests of its customers and treat them fairly
- Principle 7: A firm 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
- Principle 8: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client
- Principle 9: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgement.

Current regulatory capital requirements

6.26 Since 1 January 2016, most insurance companies in the UK are required to maintain capital in line with the Solvency II requirements as discussed in paragraphs 6.5 to 6.7.

Capital extraction

6.27 Insurers that are not in run-off are able to extract capital from the business without the PRA's prior approval.

6.28 The PRA expects insurers to maintain an adequate level of capital above the SCR both before and after the extraction of capital.

Security under wind up

6.29 The winding up of an insurance undertaking in the UK is governed by the Insurers (Reorganisation and Winding Up) Regulations 2004. Under these regulations, insurance claims take precedence over other claims on the insurance undertaking with the exception of certain preferential claims (for example, secured creditors, claims by employees, rights in rem etc). Therefore, direct policyholders rank equally and above inwards reinsurance policyholders and all other unsecured/non preferential creditors in the event that an insurer is wound up.

Financial Services Compensation Scheme

6.30 FSCS is the compensation fund of last resort for customers of authorised financial services firms. It is a statutory scheme funded by levies on firms authorised by the PRA and the FCA. It provides compensation to individual holders of policies issued by UK insurers in the UK or in another EEA state who are eligible for compensation under the FSCS in the event of an insurer's default.

6.31 Most private policyholders, small businesses and charities are eligible for protection from the FSCS, in the event that an insurer is unable to meet its liabilities. The FSCS will pay 100% of any claim incurred for compulsory insurance such as third-party motor and employers' liability insurance). If the cover was bought direct from the insurer, it will also pay 100% of any claim for professional indemnity insurance and claims arising from death or incapacity of the policyholder due to injury, sickness or infirmity and 90% of all other covered policies, with no upper limit on the amount payable. Where a policy was bought through a failed broker, the payment is 100% for compulsory insurance and 90% for all other covered policies. The FSCS does not protect aircraft, ships, goods in transit, aircraft liability, liability of ships or credit insurance, nor does it protect contracts of reinsurance.

6.32 As well as providing cover for risks situated in the UK written by UK authorised insurance companies, it also provides cover for risks situated in other EEA states written by an insurer authorised in the UK.

6.33 The impact of the Scheme on the level of compensation available to policyholders is discussed in Section 9

Financial Ombudsman Service

6.34 The Financial Ombudsman Service ("FOS") was set up as an independent public body. Its job is to resolve individual disputes between consumers and financial services businesses. The FOS has jurisdiction to determine complaints in respect of business carried on by firms from establishments in the UK.

6.35 Eligible complainants are defined as:

- A consumer, which for these purposes is an individual acting for purposes which are wholly or mainly outside that individual's trade, business, craft or profession
- A micro-enterprise, which is an enterprise that employs fewer than 10 persons and has a turnover or annual balance sheet that does not exceed £2m
- A charity with an annual income of less than £6.5m at the time the complainant referred the complaint to the relevant firm
- A trustee of a trust which has a net asset value of less than £5m at the time the complainant referred the complaint to the relevant firm
- A small business at the time the complainant referred the complaint to the relevant firm. This is a business that is not a micro-enterprise, that has an annual turnover of less than £6.5m and either employs fewer than 50 persons or has a balance sheet of less than £5m
- A guarantor, which is an individual who is not a consumer and has given a guarantee or security in respect of an obligation or liability of a person which was a micro-enterprise or small business at the date the guarantee or security was given.

6.36 The impact of the Scheme on the access to FOS of the affected policyholders is discussed in paragraphs 11.21 to 11.34

Overview of Irish regulations

6.37 Irish insurers are regulated by the CBI. The Central Bank Reform Act 2010 created the new single unitary body, the CBI, which replaced the previous related entities, the Central Bank and Financial Services Authority of Ireland and the Irish Financial Services Regulatory Authority.

6.38 Its statutory objectives include the following:

- stability of the financial system overall
- resolution of financial difficulties in credit institutions
- regulation of financial service providers and markets
- the provision of analysis and comment to support national economic policy development
- efficient and effective operation of payment and settlement systems.

Current regulatory capital requirements

6.39 Since 1 January 2016, most insurance companies in Ireland are required to maintain capital in line with the Solvency II requirements as discussed in paragraphs 6.5 to 6.7.

Capital extraction

6.40 For insurers that continue to sell policies and are a going concern, there is no formal requirement placed on the insurer by the CBI with regards to capital extraction, other than that it must maintain its SCR. However, it is commonplace for insurers to hold a buffer above its SCR and, in practice, the CBI expects that insurers will maintain a sufficient buffer.

Consumer protection

6.41 The CBI has a role in ensuring that the best interests of consumers of financial services are protected.

6.42 It has in place The Consumer Protection Directorate (CPD) which is involved in the development, implementation and supervision of all financial conduct of business regulations for all types of regulated entities. The CPD aims to deliver on its consumer protection mandate in the context of three important desired consumer protection outcomes:

- a positive consumer-focused culture that is embedded and demonstrated within all firms
- a consumer protection framework that is fit for purpose and ensures that consumers' best interests are protected
- regulated firms that are fully compliant with their obligations and are treating their customers, existing and new, in a fair and transparent way.

Security under wind up

6.43 In Ireland, the winding up of an insurance undertaking is governed by the European Union (Insurance and Reinsurance) Regulations 2015. Under these regulations, insurance claims take precedence over other claims on the insurance undertaking with respect to the assets representing the technical provisions.

Compensation

6.44 The Insurance Compensation Fund ("ICF") is a fund of last resort in Ireland. The ICF is primarily designed to facilitate payments to policyholders in relation to risks situated in Ireland where an Irish authorised non-life insurer or a non-life insurer authorised in another European Member State goes into liquidation. It does not cover risks written by an insurer regulated by the CBI that are situated in another EEA state. Note that any payments from the ICF are subject to approval from the High Court and not all policyholder liabilities are covered by the ICF.

6.45 The operation of the ICF was recently transferred from the Office of the Accountant of the High Court to the Central Bank.

6.46 Payments made by the ICF are limited to the lesser of 65% of the sum due to the policyholder and €825,000.

6.47 However, in the case of third-party motor insurance claims, where an insurer is in liquidation the ICF will pay 100% of the award. The amount of this award over the aforementioned cap of the lesser of 65% or €825,000 is recouped from the Motor Insurance Bureau of Ireland (MIBI), who collects the balance from motor insurers through an industry ex-ante fund which the MIBI manages.

6.48 Note that commercial policyholders are not covered by the ICF unless the claim is in respect of a liability to an individual. In addition, not all policyholder liabilities are covered by the ICF and excluded risks include health, dental and life policies.

Financial Services and Pensions Ombudsman

6.49 Complaints against a financial services firm in Ireland can be made through the Financial Services and Pensions Ombudsman ("FSPO"). The FSPO is a statutory officer who deals independently with unresolved complaints from consumers about their individual dealings with all financial service providers. The financial services provider must be registered and authorised by the CBI.

6.50 Eligible claimants, subject to turnover limitations, are defined to be:

- Private individuals – personal policy or account holders
- Limited companies
- Sole traders
- Trusts
- Clubs
- Charities
- Partnerships

6.51 The FSPO is discussed further in paragraphs 11.21 to 11.34.

7 Claims Reserves

7.1 In this section, I discuss the claims reserve strength of the Transferring Portfolio, the Remaining Portfolio and the Existing Portfolio. In doing so, I have considered the following:

- The best estimate claims reserves for the Transferring Portfolio as calculated by AIUK and reviewed by AIEU
- The adjustments applied by AIUK to the best estimate claims reserves to determine the Solvency II technical provisions for the Transferring Portfolio
- The adjustments applied by AIEU to the best estimate claims reserves to determine the Solvency II technical provisions for the Transferring Portfolio
- The best estimate claims reserves for the Remaining Portfolio as estimated by AIUK and the adjustments applied by AIUK to the best estimate claims reserves to determine the Solvency II technical provisions for the Remaining Portfolio
- Two external reports which reviewed the appropriateness of the best estimate claims reserves for AIUK's total portfolio as at 31 December 2019 (that is, the total of the Remaining Portfolio and the Transferring Portfolio)
- The best estimate claims reserves for the Existing Portfolio as estimated by AIEU and the adjustments applied by AIEU to the best estimate claims reserves to determine the Solvency II technical provisions for the Existing Portfolio
- The governance processes relating to the reserves of AIUK and AIEU
- The impact of COVID-19 on the best estimate reserves and Solvency II technical provisions for AIUK and AIEU.

7.2 This section is set out as follows:

- Paragraphs 7.7 to 7.37 discuss: the Remaining Portfolio; the processes undertaken by AIUK in setting the best estimate claims reserves and Solvency II technical provisions including my opinion on the robustness of these processes; and my opinion on the strength of the best estimate claims reserves and the Solvency II technical provisions.
- Paragraphs 7.38 to 7.55 discuss: the Existing Portfolio; the processes undertaken by AIEU in setting the best estimate claims reserves and Solvency II technical provisions including my opinion on the robustness of these processes; and my opinion on the strength of the best estimate claims reserves and the Solvency II technical provisions.
- Paragraphs 7.56 to 7.68 discuss: the Transferring Portfolio; the processes undertaken by AIUK and AIEU in setting the best estimate claims reserves and Solvency II technical provisions including my opinion on the robustness of these processes; and my opinion on the strength of the best estimate claims reserves and the Solvency II technical provisions estimated by AIUK and AIEU.
- Paragraphs 7.69 to 7.90 discuss: the impact of COVID-19 on the Remaining Portfolio, the Existing Portfolio and the Transferring Portfolio.

7.3 For the avoidance of doubt, the figures presented in paragraphs 7.6 to 7.68, and my analyses and conclusions in these sections, do not consider the impact of COVID-19. I consider this separately in paragraphs 7.69 to 7.90.

7.4 The reserve reviews that I have considered in this section were the most recent available at the time of my analysis. For my Supplementary Report, I will consider claims movements since these reviews and any more recently available actuarial reserve reviews.

7.5 I have also compared AIUK's and AIEU's best estimate claims reserves to their published financial statements as at 31 December 2019. AIUK and AIEU present their financial statements under the Generally Accepted Accounting Principles ("GAAP") basis that is applicable to the country of their domicile i.e. AIUK reports on a UK-GAAP basis while AIEU presents its figures on an Irish-GAAP basis. I have discussed the differences between the two regimes with senior accountants at Grant Thornton who specialise in the insurance sector and, based on those discussions, I do not expect the differences between the two bases to have a material impact on my analysis and opinions in this section.

7.6 For the avoidance of doubt, the tables illustrated in the remainder of Section 7 pertain to the best estimate claims reserves, rather than the GAAP reserves.

Remaining Portfolio

AIUK's reserving process

7.7 In general, AIUK assesses its best estimate claims reserves and Solvency II technical provisions on a quarterly basis, including a full reserve review followed by the calculation of the additional adjustments required to determine the Solvency II technical provisions.

7.8 The best estimate claims reserves and the Solvency II technical provisions for the Transferring Portfolio have been calculated within AIUK's quarterly reserving process, As at 31 December 2019 AIUK's reserving process was for its total portfolio – that is, for both the Remaining Portfolio and the Transferring Portfolio.

7.9 To identify claims belonging to the Remaining Portfolio and the Transferring Portfolio, AIUK has segmented its claims information for AIUK's total portfolio by currency. Claims are identified as belonging to the Transferring Portfolio if they are denominated in either Euro or other EEA currencies, with the exception of Pound Sterling.

7.10 AIUK has informed me that there are approximately £0.1m of gross outstanding claims where the original currency is denominated in either Euro or other EEA currencies but are processed as part of the Remaining Portfolio. I do not consider this to be a material issue for the following reasons:

- AIUK has informed me that, while this £0.1m of gross outstanding claims is originally treated as part of the Remaining Portfolio, the corresponding best estimate claims reserves will be moved over to the Transferring Portfolio
- £0.1m is less than 0.1% of the gross best estimate claims reserves of £302.7m for the Remaining Portfolio and less than 0.1% of the gross best estimate claims reserves of £200.4m for the Transferring Portfolio as at 31 December 2019 and is therefore, in my opinion, immaterial.

7.11 For these segmented claims, data is grouped into segmented claims triangles split by line of business in an identical manner to AIUK's standard reserving processes. AIUK then calculates the incurred-but-not-reported ("IBNR") reserves on the assumption that the claims experience for each class and year of account for both segments of the business are identical to that for the whole portfolio; that is, the triangles not split by currency. In other words, it makes the same development assumptions for the Remaining Portfolio and the Transferring Portfolio.

7.12 It does this by applying the same incurred-to-ultimate factors to each year of account in the segmented triangles to calculate the ultimate loss for each year of account for each of the Remaining Portfolio and the Transferring Portfolio. These incurred-to-ultimate factors were derived from AIUK's quarterly reserving process. The best estimate claims reserves for the Remaining Portfolio and the Transferring Portfolio are then calculated as the ultimate loss less paid claims to date.

7.13 I understand from AIEU that the significant majority of the policies written via AIUK's largest coverholder and the claims arising from those policies are denominated in Euro or other EEA currencies other than Pound Sterling. It follows that the vast majority of claims in the Transferring Portfolio are denominated in these currencies. For the rest of the portfolio, AIUK has informed me that policies and claims will be accounted for in the most appropriate currency but that these comprise a relatively small proportion of the Transferring Portfolio.

7.14 I do not consider the methodology used to split the reserves for the Transferring Portfolio from those for the Remaining Portfolio to be unreasonable. In reaching this conclusion I have considered the following:

- The reserves in the Transferring Portfolio pertain to policies domiciled in EEA jurisdictions. I therefore do not consider it to be unreasonable to assume that the liabilities arising from these policies would be denominated in Euro or other EEA currencies other than Pound Sterling
- The information and justifications provided by AIUK and AIEU as documented in paragraphs 7.13 and 7.20.
- I do not consider it unreasonable to not perform a separate set of reserving calculations for the Transferring Portfolio. I understand from AIUK that the business in AIUK's total portfolio was not historically separated between UK and EEA policies; that is, prior to the Scheme, the underwriting teams responsible for AIUK's total portfolio wrote some UK business and some EEA business while following the same underwriting guidelines. Therefore, at a class-by-class level, it is not unreasonable to assume that the business written is similar across the Remaining Portfolio and the Transferring Portfolio.

7.15 I discuss the best estimate claims reserves of the Transferring Portfolio further in paragraphs 7.61 to 7.62.

7.16 AIUK has informed me that its GAAP claims reserves have no margin in excess of its best estimate claims reserves and that the GAAP reserves are set as equal to the best estimate claims reserves. For the avoidance of doubt, other provisions such as unallocated loss adjustment expenses ("ULAE") are presented separately.

7.17 As I discussed in paragraph 7.8, the Solvency II technical provisions for the Transferring Portfolio have been calculated within AIUK's quarterly reserving process. I understand from AIUK that it initially calculated the Solvency II technical provisions for the Transferring Portfolio. I further understand from AIUK that these were based on the Euro or other EEA-denominated best estimate claims reserves, other than Pound Sterling. It then calculated the Solvency II technical provisions for the whole of AIUK (i.e., the total of the Remaining Portfolio and the Transferring Portfolio) before calculating the Solvency II Technical Provisions for the Remaining Portfolio as the difference between the Solvency II technical provisions for AIUK's total portfolio and the Solvency II Technical Provisions for the Transferring Portfolio.

7.18 I do not consider the methodology used to split AIUK's Solvency II Technical Provisions between the Remaining Portfolio and the Transferring Portfolio to be unreasonable. In reaching this conclusion I have considered the following:

- The reserves in the Transferring Portfolio pertain to policies domiciled in EEA jurisdictions. I therefore do not consider it to be unreasonable to assume that the liabilities arising from these policies would be denominated in Euro or other EEA currencies other than Pound Sterling
- The information and justifications provided by AIUK and AIEU as documented in paragraph 7.13 and 7.20.
- I do not consider it unreasonable to not perform a separate set of Technical Provisions calculations for the Remaining Portfolio. I understand from AIUK that the business in AIUK's total portfolio was not historically separated between UK and EEA policies; that is, prior to the Scheme, the underwriting teams responsible for AIUK's total portfolio wrote some UK business and some EEA business while following the same underwriting guidelines. Therefore, at a class-by-class level, it is not unreasonable to assume that the business written is similar across the Remaining Portfolio and the Transferring Portfolio.

7.19 I discuss the Solvency II technical provisions of the Transferring Portfolio further in paragraphs 7.63 to 7.68.

7.20 AIUK and AIEU have informed me that neither entity plans to change the methodology used to split the reserves and Solvency II Technical Provisions for the Transferring Portfolio from those for the Remaining Portfolio going forwards. AIUK has informed me that, given that the significant majority (98.2% of policies, as I described in paragraph 5.23) of business in the Transferring Portfolio is written via AIUK's largest coverholder and that, as discussed in paragraph 7.13, the significant majority of claims arising from the policies written via this coverholder are denominated in Euro or another EEA currency other the Pound Sterling, it considers the current methodology to split the Transferring Portfolio from AIUKs total portfolio to be reasonable and sufficiently accurate as to not require changing.

7.21 I do not consider AIUK and AIEU's decision to maintain the methodology used to split the best estimate claims reserves and Solvency II Technical Provisions for the Transferring Portfolio from those for the Remaining Portfolio going forwards to be unreasonable. In reaching this conclusion I have considered the following:

- AIUK's total portfolio (that is, both the Remaining Portfolio and the Transferring Portfolio) has a broadly homogenous risk profile and I therefore would not expect the considerations I took to reach my conclusion in paragraph 7.14 to change following the Scheme.
- AIUK has informed me that, in isolation, the claims data for the Transferring Portfolio is not sufficiently credible to enable standard actuarial projection methods to produce robust estimates.
- As I discussed in paragraph 5.9, from 1 January 2020, AIUK ceased writing non-UK EEA business, other than a small book of 40 policyholders, and all other non UK EEA policies have since been written by AIEU in its P&C Division and there is no new business being written in the Transferring Portfolio. It follows that the credibility in the previous bullet point would reduce over time as claims continue to settle.

7.22 I understand from AIUK that its actuarial team has regular discussions with the claims and underwriting teams throughout the reserving process, including discussion of the selected loss development factors with the underwriting teams as part of a monthly actual versus expected exercise. I further understand from AIUK that the reserving team also discuss large losses, claims issues and catastrophe claims with the Head of Claims before initial quarterly reserve projections are carried out.

7.23 The best estimate claims reserves and Solvency II technical provisions estimated by AIUK for the Remaining Portfolio are subject to several layers of peer reviews which take place for every reserving exercise. These are:

- Reviews and challenges of actuarial projections by the Chief Actuary
- Discussions of the Chief Actuary's reserve recommendations at Reserve Committee meetings which are attended by the following members of AIUK:
  - Chief Executive Offer
  - Chief Financial Officer
  - Chief Risk Officer
  - Chief Actuary
  - Chief Underwriting Officers
  - Chief Claims Officer
  - Independent Non-Executive Directors
  - Reserving Actuary
  - Pricing Actuary
- An independent peer review of the actuarial projections by Arch Insurance Group Inc. ("AIGI"), a US-based subsidiary of ACGL. This review is overseen by AIGI's Chief Actuary.

7.24 In addition to the quarterly processes above, I understand from AIUK that its external auditor also undertakes an annual review of the best estimate claims reserves and Solvency II technical provisions annually. I also understand from AIUK that it commissions an annual external review of its best estimate reserves as at 30 September ("Q3") and 31 December ("Q4") by an Actuarial Consultancy firm:

- The external audit was last performed as at 31 December 2019. The auditors reviewed the reserves for AIUK using a combination of independent projections and reviews of methodologies and assumptions.
- The external review by the Actuarial Consultancy firm was last performed as at 31 December 2019. The Actuarial Consultancy firm produced an independent set of ultimate claims estimates for all underwriting years and lines of business with additional deep dives on specific classes.

7.25 AIUK has informed me that its reserving process and the governance currently in place in respect of reserving will continue to apply to the Remaining Portfolio following the Scheme.

7.26 Based on my experience and my knowledge of the market, my view is that the process for setting the best estimate claims reserves and Solvency II technical provisions at AIUK appears to be appropriate and robust for the following reasons:

- The process followed is in line with processes that are regularly used elsewhere
- There are sufficiently experienced individuals conducting the analysis as I conclude in paragraphs 7.29 and 7.35
- There are several layers of review performed, giving the opportunity for a number of people to challenge the analysis and results.

Best estimate claims reserves

7.27 The table below shows the best estimate claims reserves at 31 December 2019, both gross and net of reinsurance. While there have been further quarterly reserve reviews since this date, AIUK has informed me that, at the time of writing this report, there have been no material changes to the methodology used. As I discussed in paragraph 7.24, these figures as at 31 December 2019 were subject to reviews by the external auditors and an external Actuarial Consultancy and the quarterly reviews since this date have not been subject to these additional reviews.

7.28 For the avoidance of doubt these figures are only in relation to the Remaining Portfolio and they do not include the reserves for the Transferring Portfolio. In addition, they do not include ULAE or other reserves such as reinsurance bad debt.

Table 7.1: Best estimate claims reserves for the Remaining Portfolio at 31 December 2019

£m	Gross of reinsurance	Ceded external reinsurance	Ceded Intercompany Quote Share RI	Net of reinsurance
Best estimate claims reserve	302.7	105.6	167.5	29.6

7.29 I have performed an analysis to satisfy myself that AIUK's best estimate of its claims reserves is consistent with my expectations for insurance business of the nature that it writes. This analysis involved:

- A review of AIUK's reserve report dated 23 January 2020 which was based on data as at 31 December 2019
- A review of the reserving section from AIUK's Actuarial Function Report which discusses the claims reserves of AIUK as at 31 December 2019
- A review of AIUK's reserving policy setting out its reserving methodology, process and governance

- A review of the methods used by AIUK to estimate the reserves compared with industry best practice
- A review of the approach used to split AIUK's total reserves between the Remaining Portfolio and the Transferring Portfolio
- A review of the methods used by the Actuarial Consultancy firm that I mentioned in paragraph 7.10 to estimate the reserves compared with industry best practice
- A review of the methods used by the external auditors to estimate the reserves compared with industry best practice
- Discussions with individuals at AIUK to understand the approach it has used to estimate the best estimate claims reserves and whether any material changes have occurred to the processes since the date of the information received
- A review of the CVs of the individuals at AIUK who were responsible for the reserving analysis.
- AIUK review of the profile of the director at the Actuarial Consultancy I referred to in paragraph 7.24
- A review of the profiles of the individuals at the external audit firm I referred to in paragraph 7.24

7.30 AIUK applies a variety of reserving methods depending on the class of business, peril and year being reserved. In general, claims which typically settle relatively quickly are projected using a chain-ladder approach, while claims which typically settle over a longer period of time rely on expected loss ratios with additional weight being given to historical experience as it emerges.

7.31 I believe that the best estimate claims reserves for the Remaining Portfolio lie within a range of reasonable estimates. In reaching this assessment, I have considered the following:

- I have concluded that AIUK's best estimate claims reserving process appears appropriate and robust in paragraph 7.26
- I have concluded that the methodology that AIUK has used for splitting the Transferring Portfolio and Remaining Portfolio from its total portfolio is not unreasonable in paragraph 7.14.
- AIUK has utilised market standard approaches in determining its best estimate claims reserves
- The assumptions utilised by AIUK in determining its best estimate claims reserves appear reasonable
- The reasonableness of the outputs compared to the historical experience
- Both reviews that I mentioned in paragraph 7.24 have calculated reserve estimates that are, in total, lower than those set by AIUK; that is, they have identified surpluses in the reserves set by AIUK. I have reviewed the reports documenting both of these reviews, including the approaches taken and the conclusions reached, and I have considered them in the light of market practice and my experience and expertise. Having done so, I am satisfied that the analyses and conclusions are reasonable.
- I am satisfied that the individuals at AIUK I referred to in paragraph 7.24 who were responsible for the reserving analyses and calculation of the best estimate claims reserves have the necessary experience and expertise to undertake reviews of this nature and for me to rely on their reviews. In reaching this conclusion I have considered the following:
  - The number of years they have spent working as actuaries in the non-life insurance industry
  - The levels of positions held
  - The relevance of their experience in the non-life insurance industry against the reviews and analysis that have been carried out

- I am satisfied that the director at the Actuarial Consultancy I referred to in paragraph 7.24 who was responsible for the reserving analyses has the necessary experience and expertise to undertake reviews of this nature and for me to rely on their reviews. In doing so I have considered the following:
  - The number of years they have spent working as actuaries in the non-life insurance industry
  - The levels of positions held
  - The relevance of their experience in the non-life insurance industry against the reviews and analysis that have been carried out
- I am satisfied that the individuals at the external audit firm I referred to in paragraph 7.24 who was responsible for the reserving analyses and independent verification of the best estimate claims reserves has the necessary experience and expertise to undertake reviews of this nature and for me to rely on their reviews. In doing so I have considered the following:
  - The number of years they have spent working as actuaries in the non-life insurance industry
  - The levels of positions held
  - The relevance of their experience in the non-life insurance industry against the reviews and analysis that have been carried out
- My experience and expertise relating to claims reserving.

Solvency II technical provisions

7.32 The Solvency II technical provisions are the sum of the discounted best estimate of the future claims, premium and expense cashflows as defined under Solvency II, and a risk margin.

7.33 The table below shows the Solvency II technical provisions for the Remaining Portfolio as at 31 December 2019, both gross and net of reinsurance. For the avoidance of doubt these figures are only in relation to the Remaining Portfolio and they do not include the technical provisions for the Transferring Portfolio.

Table 7.2: Solvency II technical provisions for the Remaining Portfolio at 31 December 2019

£m	Best estimate	Risk margin	Technical provisions
Gross of reinsurance	354.7		358.3
Ceded external reinsurance	96.0		96.0
Ceded Intercompany Quota Share RI	207.4		207.4
Net of reinsurance	51.3	3.6	54.9

7.34 AIUK calculates its Solvency II technical provisions by applying the adjustments which are discussed in paragraph 6.11to the best estimate claims reserves.

7.35 I have performed an analysis to satisfy myself that AIUK's estimate of the Solvency II technical provisions is consistent with my expectations for insurance business of the nature that it writes. This analysis involved:

- An analysis to satisfy myself that AIUK's best estimate claims reserves are consistent with my expectations for insurance business of the nature that it writes, as discussed in paragraph 7.29
- A review of AIUK's Actuarial Function Report at 31 December 2019 (the latest date at which an Actuarial Function Report is available) which sets out the adjustments made to the best estimate claims reserves to derive the Solvency II technical provisions

- A comparison of the methods used to estimate the Solvency II technical provisions with my experience of industry best practice
- A review of the approach used to split AIUK's total Solvency II technical provisions between the Remaining Portfolio and the Transferring Portfolio
- A review of the CVs of the individuals who are responsible for the calculation of the Solvency II technical provisions. Based on these and my interactions with those individuals, I am satisfied that the actuaries at AIUK who undertook these calculations have the necessary experience and expertise to undertake an analysis of this nature and for me to rely on their analysis.
- Discussions with individuals at AIUK to understand the approaches used to estimate the Solvency II technical provisions. These discussions have also involved considering whether any material changes have occurred to the processes since the date of the information received.

7.36 I believe that the Solvency II technical provisions for the Remaining Portfolio lie within a range of reasonable estimates. In reaching this assessment, I have considered the following:

- I have concluded that AIUK's reserving and Solvency II technical provisions process appears appropriate and robust as described in paragraph 7.35
- I have concluded that I have no reason to believe that the best estimate claims reserves for the Remaining Portfolio lie outside a range of reasonable estimates as described in paragraph 7.31
- Where AIUK has made adjustments to the best estimate claims reserves, it has utilised market standard approaches in making such adjustments and I consider the adjustments to be reasonable
- I have concluded that the methodology that AIUK has used for splitting the Transferring Portfolio and Remaining Portfolio from its total portfolio is not unreasonable in paragraph 7.14
- The analyses that AIUK has conducted in relation to its own experience are appropriate
- The reasonableness of the outputs compared to the historical experience
- I am satisfied that the individuals at AIUK who were responsible for the analysis have the necessary experience and expertise to undertake an analysis of this nature and for me to rely on their analysis
- My experience and expertise in relation to Solvency II technical provisions.

7.37 I note that there is inevitably uncertainty regarding the appropriate level of adjustments to make in order to estimate the technical provisions under Solvency II. AIUK could have made other equally valid adjustments which would lead to different results.

Existing Portfolio

7.38 As I discussed in paragraphs 5.38 to 5.43, AIEU is split into three divisions:

- Mortgage Insurance, which commenced writing business in 2011
- Alwyn Europe, which was formed in 2019 and comprises of Motor and Pet insurance business distributed by five MGAs
- P&C, which was formed in 2019 and began writing EEA business renewed from AIUK which would have otherwise comprised part of the Transferring Portfolio.

7.39 AIEU's Irish GAAP claims reserves are 1.2% greater on a gross basis and 1.6% greater on a net basis than its actuarial best estimate claims reserves. These differences represent the total Unallocated Loss Adjustment Expenses ("ULAE") for the P&C Division being presented as part of the Irish GAAP reserves in addition to the best estimate claims reserves. AIEU has informed me that the GAAP reserves for the Mortgage Insurance and Alwyn Europe Divisions do not include ULAE, and that ULAE is presented separately. Consequently, for these two divisions there is no difference between the actuarial best estimate claims reserves and the GAAP reserves. AIEU has informed me that the GAAP reserves are set equal to the best estimate claims reserves with the exception of ULAE.

7.40 AIEU considers all three divisions on a best estimate basis as a starting point (that is, excluding any ULAE), and then separately applies an expense loading capturing ULAE across all three divisions as part of its overall methodology to derive the Solvency II technical provisions. As I mentioned in paragraph7.16, AIUK has no margin in excess of its best estimate claims reserves for its GAAP reserves and ULAE is presented separately. In my opinion, both approaches are reasonable. In reaching this opinion I have considered the following:

- Both approaches are widely used as standard market procedures
- Where ULAE is not included within the GAAP reserves, it is accounted for elsewhere
- The ULAE for each entity is small as a percentage of its overall reserves.

AIEU's reserving process

7.41 I understand from AIEU that it calculates its reserves and Solvency II technical provisions on a quarterly basis and works closely with its underwriting and finance teams to obtain the data necessary to conduct its reserving processes.

7.42 The best estimate claims reserves and Solvency II technical provisions for the Existing Portfolio are subject to several layers of validations and reviews which take place for every reserving exercise. These are:

- Quarterly reserve changes for the Mortgage Insurance and Alwyn Europe Divisions are reviewed by the Finance, Actuarial, Underwriting and Claims teams as part of a quarterly change review process
- Quarterly reserves for the P&C Division are subject to the same levels of review and challenges that I set out in paragraph 7.23 for AIUK
- Data checks and validations are carried out for both the claims reserves and the Solvency II technical provisions for all three divisions
- Reviews and challenges of actuarial projections for all three divisions are provided by AIEU's Head of Actuarial Function
- Reviews of all information in AIEU's Quantitative Reporting Templates by AIEU's Audit Committee, which comprises of two independent Non-Executive Directors and one Non-Executive Director.

7.43 While initial reserve recommendations for the Mortgage Insurance and Alwyn Europe Divisions are produced internally within AIEU, the initial recommendations for AIEU's P&C Division's best estimate claims reserves and Solvency II Technical Provisions are provided by staff at AEIS, with AIEU's Head of Actuarial Function providing challenge and, ultimately the final sign-off. AIEU's P&C Division is currently comprised of EEA business which would previously have been written by AIUK, and therefore is very similar business to the Transferring Portfolio. I understand from AIEU that staff at AEIS will continue to make recommendations for the P&C Division (that is, for both business written as part of the Existing Portfolio which would otherwise have comprised part of the Transferring Portfolio, and the Transferring Portfolio itself) after the Scheme, with AIEU satisfying itself of these recommendations, continuing to raise challenges where appropriate and, ultimately, providing sign-off.

7.44 Based on my experience and my knowledge of the market, my opinion is that the processes for setting the best estimate claims reserves and Solvency II technical provisions at AIEU appears to be appropriate and robust for the following reasons:

- The processes followed are in line with processes that are regularly used elsewhere
- There are sufficiently experienced individuals conducting the analysis

- There are several layers of review performed, giving the opportunity for a number of people to challenge the analysis and results.

Best estimate claims reserves

7.45 The table below shows the best estimate claims reserves for the Existing Portfolio as at 31 December 2019.

7.46 For the avoidance of doubt, these figures are for the Existing Portfolio only and exclude any additional differences which form AIEU's GAAP reserves.

Table 7.4: Best estimate claims reserves for the Existing Portfolio as at 31 December 2019

£m	Gross of reinsurance	Ceded external reinsurance	Ceded Intercompany Quota Share RI	Net of reinsurance
Best estimate claims reserve	21.9	1.7	17.7	2.5

7.47 I have been provided with AIEU's Actuarial Report on Technical Provisions ("ARTP") which outlines the quarterly reserving process for its best estimate and GAAP reserves. As I discussed in paragraph 7.39, the difference between AIEU's best estimate claims reserves and its GAAP reserves is relatively small and represents the ULAE for AIEU's P&C Division

7.48 I have performed an analysis to satisfy myself that AIEU's best estimate claims reserves for the Existing Portfolio are consistent with my expectations for insurance business of the nature that it writes. This analysis involved:

- A review of AIEU's ARTPs as at 31 December 2019 in respect of the Existing Portfolio. This report was produced by AIEU's Head of Actuarial Function and the report covers its entire portfolio. The report sets out the results of AIEU's calculation of the best estimate claims reserves and Solvency II technical provisions, as well as the methodologies and key assumptions underlying these calculations.
- A review of the methods used by AIEU to estimate the reserves in the exercises discussed in the previous bullet point compared with industry best practice
- Discussions with individuals at AIEU to understand the approach it has used to estimate the best estimate claims reserves and whether any material changes have occurred to the processes since the date of the information received
- A review of the CVs of the individuals at AIEU and AIUK who were responsible for the reserving analysis and of AIEU's Head of Actuarial Function who reviewed and signed off this analysis. Based on my review of his CV and my interactions with him, I am satisfied that he has the necessary experience and expertise to review and sign-off a review of this nature and for me to rely on his review.
- The analysis which I described in paragraph 7.29 for AIUK which also pertains to the initial recommendations for the claims reserves for AIEU's P&C Division.

7.49 The best estimate claims reserves for each line of business are estimated using one of, or a combination of, the following methods:

- Expected loss ratios ("ELRs"), particularly for claims in early stages of development
- Other traditional actuarial methods such as the chain-ladder or Bornhuetter-Ferguson methods for claims with greater emerging experience.

7.50 Having reviewed the information that I set out in paragraphs 7.41 to 7.49 , I consider the best estimate claims reserves for the Existing Portfolio to lie within a range of reasonable estimates. In reaching this assessment, I have considered the following:

- I have concluded that the reserving process appears appropriate and robust in paragraph 7.48
- I am satisfied that the individuals at AIUK and AIEU who were responsible for the reserving analysis and AIEU's Head of Actuarial Function who was responsible for reviewing and signing off the analysis has the necessary experience and expertise to review and sign-off a review of this nature and for me to rely on his review
- My experience and expertise in relation to claims reserving.

Solvency II technical provisions for the Existing Portfolio

7.51 The Solvency II technical provisions are the sum of the best estimate provisions, calculated on a cash flow basis under Solvency II, and a risk margin.

7.52 The table below shows the Solvency II technical provisions for the Existing Portfolio at 31 December 2019, on a gross and net of reinsurance basis.

Table 7.5: Solvency II technical provisions for the Existing Portfolio at 31 December 2019

£m	Best estimate	Risk margin	Technical provisions
Gross of reinsurance	35.3		38.3
Ceded external reinsurance	3.6		3.6
Ceded Intercompany Quota Share RI	25.9		25.9
Net of reinsurance	5.7	3.1	8.8

7.53 AIEU calculates its Solvency II technical provisions by applying the adjustments which are discussed in paragraph 6.11 to the best estimate claims reserves.

7.54 I have performed an analysis to satisfy myself that AIEU's estimate of the Solvency II technical provisions is consistent with my expectations for insurance business of the nature that it writes. This analysis involved:

- A review of AIEU's ARTPs as at 31 December 2019 in respect of the Existing Portfolio. This report was produced by AIEU's Head of Actuarial Function and the report covers its entire portfolio. The report sets out the results of AIEU's calculation of the best estimate claims reserves and Solvency II technical provisions, as well as the methodologies and key assumptions underlying these calculations.
- An analysis to satisfy myself that AIEU's best estimate claims reserves are consistent with my expectations for insurance business of the nature that it writes, as discussed in paragraph 7.48
- Discussions with individuals at AIEU to understand the approach it has used to estimate the Solvency II technical provisions and whether any material changes have occurred to the processes since the date of the information received
- A review of the adjustments that AIEU has made to the best estimate claims reserves to derive the Solvency II technical provisions and a comparison of the methods used with industry best practice
- A review of the CVs of the individuals who are responsible for the calculation of the Solvency II technical provisions. Based on these and my interactions with those individuals, I am satisfied that the actuaries at AIEU and AIUK who undertook these calculations have the necessary experience and expertise to undertake analysis of this nature and for me to rely on their analysis

- The analysis which I described in paragraph 7.35 for AIUK which also pertains to the initial recommendations for the Solvency II technical provisions for AIEU's P&C Division.

7.55 I believe that the Solvency II technical provisions for the Existing Portfolio lie within a range of reasonable estimates. In reaching this assessment, I have considered the following:

- I have concluded that AIEU's reserving and Solvency II technical provisions process appears appropriate and robust as described in paragraph 7.44
- I have concluded in paragraph 7.50 that I have no reason to believe that the best estimate claims reserves for the Existing Portfolio lie outside a range of reasonable estimates
- I consider the adjustments made by AIEU to the best estimate claims reserves to calculate the Solvency II technical provisions to be appropriate and in line with industry practice
- The reasonableness of the outputs compared to the historical experience
- I am satisfied that the individuals at AIEU and AIUK who were responsible for the analysis have the necessary experience and expertise to undertake analysis of this nature and for me to rely on their analysis
- My experience and expertise in relation to Solvency II technical provisions.

I note that there is inevitably uncertainty about the appropriate level of adjustments to make in order to estimate the technical provisions under Solvency II. It follows that AIEU could have made equally valid adjustments which would lead to different results.

Transferring Portfolio

Reserving process for the Transferring Portfolio

7.56 As I discussed in paragraph 7.8, the reserves for the Transferring Portfolio have been calculated within AIUK's quarterly reserving process along with the Remaining Portfolio. AIUK's reserving calculations were done for its total portfolio and then split between the Remaining Portfolio and the Transferring Portfolio as described in paragraphs 7.9 to 7.13.

7.57 It follows that, as at 31 December 2019, the sum of the best estimate claims reserves for the Remaining Portfolio and the Transferring Portfolio are equal to the best estimate claims reserves for AIUK's total portfolio, and the sum of the Solvency II technical provisions for the Remaining Portfolio and the Transferring Portfolio are equal to the Solvency II technical provisions for AIUK's total portfolio.

7.58 As at 31 December 2019, the best estimate claims reserves and Solvency II technical provisions for the Transferring Portfolio are identical for both AIUK and AIEU, with the exception of the Solvency II risk margin which I discuss in paragraphs 7.64 and 7.65.

7.59 As I discussed in paragraph 7.43, AIEU reviews and challenges AIUK's best estimate claims reserves and Solvency II Technical Provisions for AIEU's P&C Division. AIEU has followed this same process for reviewing the best estimate claims reserves and Solvency II technical provisions for the Transferring Portfolio, which will be transferring into AIEU's P&C Division.

Best estimate claims reserves

7.60 The table below shows AIUK's and AIEU's identical estimates of the gross and net best estimate claims reserves for the Transferring Portfolio as at 31 December 2019.

Table 7.5: Best estimate claims reserves for the Transferring Portfolio at 31 December 2019

£m	Best estimate claims reserves
Gross of reinsurance	200.4
Ceded external reinsurance	90.7
Ceded Intercompany Quota Share RI	93.3
Net of reinsurance	16.5

7.61 I have performed an analysis to satisfy myself that AIUK's best estimate claims reserves for the Transferring Portfolio are consistent with my expectations for insurance business of a similar nature. This analysis involved:

- A review of AIUK's reserve report dated 23 January 2020 which was based on data as at 31 December 2019
- A review of the reserving section from AIUK's Actuarial Function Report which discusses the best estimate claims reserves of AIUK as at 31 December 2019
- A review of AIUK's reserving policy setting out its reserving methodology, process and governance
- A review of the methods used by AIUK to estimate the reserves compared with industry best practice
- A review of the approach used to split AIUK's total reserves between the Remaining Portfolio and the Transferring Portfolio that I discussed in paragraphs 7.9 to 7.12
- A review of the methods used by the Actuarial Consultancy firm that I mentioned in paragraph 7.24 to estimate the reserves compared with industry best practice
- A review of the methods used by the external auditors to estimate the reserves compared with industry best practice
- Discussions with individuals at AIUK to understand the approach it has used to estimate the best estimate claims reserves and whether any material changes have occurred to the processes since the date of the information received
- A review of the CVs of the individuals at AIUK who were responsible for the reserving analysis.

7.62 I consider the best estimate claims reserves for the Transferring Portfolio to lie within a range of reasonable estimates. In reaching this assessment, I have considered the following:

- That both the Remaining Portfolio and the Transferring Portfolio are considered together as part of AIUK's quarterly reserving process
- That the methodology and processes to calculate the best estimate claims reserves for the Remaining Portfolio that I discussed in paragraphs 7.7to 7.26 are identical for the Transferring Portfolio,
- The analysis that I performed in paragraph 7.29 pertaining to the appropriateness of the best estimate claims reserves for the Remaining Portfolio
- That AIEU has followed the same process for reviewing the best estimate claims reserves for the Transferring Portfolio as it has for its P&C Division, which is where the Transferring Portfolio is being transferred to. I considered the reasonableness of this approach in paragraph 7.44

- That I consider the process for splitting the Transferring Portfolio from AIUK's total portfolio that I set out in paragraphs 7.9 to 7.12 to be reasonable as I concluded in paragraph 7.14.
- That, as discussed in paragraph 7.31, I am satisfied that the individuals at AIUK I referred to in paragraph 7.24 who were responsible for the reserving analyses and calculation of the best estimate claims reserves have the necessary experience and expertise to undertake reviews of this nature and for me to rely on their reviews.
- That, as discussed in paragraph 7.55, I am satisfied that AIEU's Head of Actuarial Function who was responsible for reviewing the analysis has the necessary experience and expertise to review an exercise of this nature and for me to rely on his review
- That, as discussed in paragraph 7.31, I am satisfied that the director at the Actuarial Consultancy I referred to in paragraph 7.24 who was responsible for the reserving analyses has the necessary experience and expertise to undertake reviews of this nature and for me to rely on their reviews.
- That, as discussed in paragraph 7.31, I am satisfied that the individuals at the auditors I referred to in paragraph 7.24 who was responsible for the reserving analyses and independent verification of the claims reserves has the necessary experience and expertise
- My experience and expertise relating to claims reserving.

Solvency II best estimate technical provisions

7.63 The tables below shows the gross and net Solvency II best estimate technical provisions for the Transferring Portfolio used for reporting at 31 December 2019, as provided by each of AIUK and AIEU.

Table 7.6: AIUK Solvency II best estimate technical provisions for the Transferring Portfolio at 31 December 2019

£m	Best Estimate	Risk Margin	Technical Provisions
Gross of external reinsurance and ceded Intercompany Quota Share RI	203.6		
Net of external reinsurance and ceded Intercompany Quota Share RI	21.0	1.5	22.5

Table 7.7: AIEU Solvency II best estimate technical provisions for the Transferring Portfolio at 31 December 2019

£m	Best Estimate	Risk Margin	Technical Provisions
Gross of external reinsurance and ceded Intercompany Quota Share RI	203.6		
Net of external reinsurance and ceded Intercompany Quota Share RI	21.0	2.2	23.2

7.64 As can be seen from the table above, the Solvency II Technical Provisions for AIUK and AIEU are identical on both a gross and net basis, with the exception of the risk margin. There is a difference of £0.7m between AIUK and AIEU's estimates of the Solvency II risk margin which is driven by a recalculation of the risk margin post-transfer on the AIEU balance sheet.

7.65 I understand from AIUK and AIEU that both have employed the same calculation methodology to derive their respective risk margins. AIEU's and AIUK's risk margin calculations include an allowance for each entity's overall risk profile and the level of diversification within each entity's insurance portfolio. The differences in the risk margins calculated by these entities is driven by the differences in the risk profile and level of diversification of these two entities.

7.66 I have performed an analysis to satisfy myself that both AIUK's and AIEU's estimates of the Solvency II technical provisions for the Transferring Portfolio are consistent with my expectations for insurance business of the nature that it writes. This analysis involved:

- An analysis to satisfy myself that AIUK's best estimate claims reserves for the Transferring Portfolio are consistent with my expectations for insurance business of a similar nature, as discussed in paragraph 7.61
- A review of AIUK's Actuarial Function Report at 31 December 2019 (the latest date at which an Actuarial Function Report is available) which sets out the adjustments made to the best estimate claims reserves to derive the Solvency II technical provisions
- A comparison of the methods used by AIUK and AIEU to estimate the Solvency II technical provisions with my experience of industry best practice
- A review of the approach used to split AIUK's total Solvency II technical provisions between the Remaining Portfolio and the Transferring Portfolio
- A review of the CVs of the individuals at AIUK and AIEU who are responsible for the calculation of the Solvency II technical provisions. Based on these and my interactions with those individuals, I am satisfied that the actuaries at AIUK and AIEU who undertook these calculations have the necessary experience and expertise to undertake an analysis of this nature and for me to rely on their analysis.
- Discussions with individuals at AIUK and AIEU to understand the approaches used to estimate the Solvency II technical provisions. These discussions have also involved considering whether any material changes have occurred to the processes since the date of the information received.
- That both the Remaining Portfolio and the Transferring Portfolio are considered together as part of AIUK's quarterly reserving process
- That the methodology and processes to calculate the Solvency II technical provisions for the Remaining Portfolio that I discussed in paragraphs 7.7 to 7.26 are identical for the Transferring Portfolio
- The analysis that I performed in paragraph 7.35 pertaining to the appropriateness of the Solvency II technical provisions for the Remaining Portfolio
- The process for calculating the Solvency II technical provisions for the Transferring Portfolio that I set out in paragraph 6.11.

7.67 I believe that both AIUK and AIEU's Solvency II technical provisions for the Transferring Portfolio lie within a range of reasonable estimates. In reaching this assessment, I have considered the following:

- I have concluded that AIUK's reserving and Solvency II technical provisions process appears appropriate and robust as described in paragraph 7.35
- I have concluded that I have no reason to believe that the best estimate claims reserves for the Transferring Portfolio lie outside a range of reasonable estimates as described in paragraph 7.62
- Where AIUK and AIEU have made adjustments to the best estimate claims reserves, they have utilised market standard approaches in making such adjustments and I consider the adjustments to be reasonable
- I have concluded that the methodology that AIUK has used for splitting the Transferring Portfolio and Remaining Portfolio from its total portfolio is not unreasonable in paragraph 7.14
- The analyses that AIUK and AIEU have conducted in relation to its own experience are appropriate
- The reasonableness of the outputs compared to the historical experience

- I am satisfied that the individuals at AIUK and AIEU who were responsible for the analysis have the necessary experience and expertise to undertake an analysis of this nature and for me to rely on their analysis
- My experience and expertise in relation to Solvency II technical provisions.

7.68 I note that there is inevitably uncertainty regarding the appropriate level of adjustments to make in order to estimate the technical provisions under Solvency II. AIUK and AIEU could have made other equally valid adjustments which would lead to different results.

Impact of COVID-19

7.69 In this section, I discuss AIUK's and AIEU's estimates of the reserves in respect of COVID-19.

7.70 There is currently considerable uncertainty regarding the impact of COVID-19 as both the total losses suffered by insureds and the liability of insurers for those losses are subject to substantial uncertainty. As a result, it is possible that the current estimates could change in the future, possibly materially so. I will provide an update to these figures in my Supplementary Report.

7.71 I also note that AIUK is one of the insurers involved in the test case brought by the FCA on business interruption covers affected by COVID-19. I further note that the outcome of the test case and any subsequent appeals may materially impact the level of business interruption claims that AIUK is liable for. The outcome of this test case, once it is known, will however provide more certainty on the level of AIUK's reserves in respect of COVID-19. I will provide an update on the test case in my Supplementary Report.

7.72 I discuss the financial impact of COVID-19 on AIUK's and AIEU's capital positions in Section 8.

Impact of COVID-19 on AIUK

7.73 AIUK has provided me with its latest analysis at the time of writing this report, assessing the impact of COVID-19 for AIUK's total portfolio; that is, both the Remaining Portfolio and the Transferring Portfolio and projected to the Effective Date.

7.74 However, I have been informed by AIUK that there is no substantial exposure to COVID-19 losses within the Transferring Portfolio. As a result, AIUK's reserves in respect of COVID-19 are all allocated to the Remaining Portfolio.

7.75 For AIUK's total portfolio, it has estimated a gross deterioration in its best estimate claims reserves of £46.7m and a net deterioration of £4.7m. The gross £47.6m deterioration comprises £39.7m of Business Interruption claims, and £7.9m of Professional Liability and Executive Assurance claims. The net £4.7m deterioration comprises £3.8m of Business Interruption claims and £0.9m of Professional Liability and Executive Assurance claims.

7.76 I understand from AIUK that these estimates were developed with input from the Head of Claims. I further understand from AIUK that the estimates have been reviewed by the actuarial team within AIGI as well as having been discussed with the auditor and the Actuarial Consultancy firm I mentioned in paragraph 7.24.

7.77 I do not consider AIUK's approach to determine the impact of COVID-19 on the gross best estimate claims reserves to be unreasonable. In reaching this conclusion I have considered the following:

- I have reviewed documentation provided by AIUK to the PRA regarding the impact of COVID-19 on its best estimate claims reserves, including the methodology used to determine these estimates. I believe that the approaches and the key assumptions discussed in these updates are not unreasonable.

- The conclusions that I reached in paragraph 7.18 regarding the appropriateness of AIUK's methodology for splitting the Remaining Portfolio and Transferring Portfolio.

7.78 It follows from the above, that I consider AIUK's estimate of the impact of COVID-19 on the gross best estimate claims reserves to be within a reasonable range.

7.79 Furthermore, I do not consider AIUK's approach to determine the impact of COVID-19 on the net best estimate claims reserves to be unreasonable. In reaching this conclusion I have considered the following:

- As discussed above, I consider AIUK's estimate of the impact of COVID-19 on the gross best estimate claims reserves to be within a reasonable range.
- I have reviewed AIUK's approach to estimating the impact on the net best estimate reserves from the impact on the gross best estimate reserves, and do not consider it to be unreasonable.

7.80 I note that the IQS provides an 85% quota share to AIUK's claims liabilities. Therefore, the net impact of all losses, including the additional detriment experienced by the impact of COVID-19, is 15% of what it would be without the IQS. This significantly mitigates the financial impact of COVID-19 on AIUK's reserves and also materially reduces the uncertainty attaching to the estimate of the net impact.

7.81 It follows from the above, that I consider AIUK's estimate of the impact of COVID-19 on the net best estimate claims reserves to be within a reasonable range.

Impact of COVID-19 on AIEU

7.82 AIEU has provided me with its latest analysis at the time of writing this report, assessing the impact of COVID-19 for the Existing Portfolio projected to the Effective Date.

7.83 For the Existing Portfolio, AIEU has estimated a deterioration in its gross best estimate claims reserves of £6.5m and a net deterioration of £0.9m. These deteriorations comprise solely from an impact on AIEU's Mortgage Insurance Division. AIEU has informed me that it has reviewed the exposure to COVID-19 losses in both the Alwyn and P&C Divisions and did not identify any adjustments required to its reserves.

7.84 I understand from AIEU that these estimates have been reviewed by ACGL's Mortgage Segment Chief Actuary and presented to AIEU's Mortgage Division Senior Management. I further understand that they have been subject to AIEU's Quarterly Change Review process which involves reserves being reviewed by Finance, Actuarial and Underwriting before bookings are finalised.

7.85 For the Mortgage Insurance Division, AIEU has increased its loss ratio selections in Q1 2020 and applied this increased loss ratio selection to future earned premium. In addition, AIEU has reflected a decrease in its forecasts of premium written during 2020 and 2021.

7.86 I do not consider the approach taken by AIEU to determine the impact of COVID-19 on its gross best estimate claims reserves to be unreasonable. In reaching this conclusion I have considered the following:

- AIEU has provided me with documentation regarding the impact of COVID-19 on its financial projections, which included correspondence with the CBI and supplementary material to AIEU's latest ORSA and strategic plan. I have reviewed these documents and believe that the approaches discussed therein are not unreasonable.
- In my experience, most Motor insurers in the UK and Ireland are anticipating an improvement in results arising from COVID-19 as a result of the reducing in claim frequencies outweighing any increase in claim severities and any policyholder refunds. However, AIEU has informed me that it has not allowed for any such improvement in its projections of the impact of COVID-19. In my opinion, this may have resulted in an element of prudence in its estimates.

7.87 It follows from the above, that I consider AIEU's estimate of the impact of COVID-19 on the gross best estimate claims reserves to be within a reasonable range.

7.88 Furthermore, I do not consider AIEU's approach to determine the impact of COVID-19 on the net best estimate claims reserves to be unreasonable. In reaching this conclusion I have considered the following:

- As discussed above, I consider AIEU's estimate of the impact of COVID-19 on the gross best estimate claims reserves to be within a reasonable range.
- I have reviewed AIEU's approach to estimating the impact on the net best estimate reserves from the impact on the gross best estimate reserves, and do not consider it to be unreasonable.

7.89 I note that the IQS provides an 85% quota share to AIEU's claims liabilities, with the exception of AIEU's Mortgage Insurance division where the IQS provides a 90% quota share to AIEU's claims liabilities on risks attaching before March 2019. As a result, the net impact of all losses, including the additional detriment experienced by the impact of COVID-19, is around 10% of what it would be without the IQS. This therefore significantly mitigates the financial impact of COVID-19 on AIEU's reserves and also materially reduces the uncertainty attaching to the estimate of the net impact.

7.90 It follows from the above, that I consider AIEU's estimate of the impact of COVID-19 on the net best estimate claims reserves to be within a reasonable range.

8 Capital Requirements

8.1 In assessing the impact of the Scheme on policyholders, I have considered the solvency positions of AIUK and AIEU.

8.2 In considering the solvency position of each company, I have considered:

- Its capital strategy and its ability to access additional capital and reinsurance if required
- Its regulatory and economic capital requirements, both before and after the Scheme
- My own stress testing of AIUK's and AIEU's capital positions after the Scheme to assess the likelihood of either entity not being able to meet its liabilities over the course of the run-off of the liabilities (i.e. on an ultimate basis)
- The latest ORSA report for each of AIUK and AIEU, including the projections of future capital positions and the stress and scenario testing performed
- The AIUK's and AIEU's assessment of the impact of the COVID-19 event on their capital positions.

8.3 It should be noted that one of the key limitations of the regulatory capital requirements under Solvency II is that they only represent the amount of capital that an insurer is required to hold over the next year. When considering policyholder security, it is also important to consider whether an insurer will have sufficient assets to meet its liabilities over the course of the run-off of the business, or at least whether the risk of that not being the case is remote.

8.4 As a result, whilst I do consider the regulatory capital requirements for each insurer and the extent to which its Own Funds cover its SCR, I also conduct my own stress testing to assess the likelihood of each insurer not being able to meet its liabilities over the course of the run-off of the liabilities following the Scheme.

8.5 In addition to this, I also consider the latest ORSA produced by each insurer which sets out the insurer's view of the resilience of its capital base to being able to meet policyholder needs.

8.6 It is the combination of the five items listed in paragraph 8.2 that I consider when assessing policyholder security, although the most weighting is applied to my own stress testing since it considers the position following the Scheme and also considers the position over the course of the run-off of the liabilities.

AIUK

AIUK's capital requirements

AIUK's approach to calculating its regulatory capital requirements

8.7 AIUK uses the Standard Formula to calculate its SCR and MCR under Solvency II.

8.8 The following key risks, arising in the next 12 months, are modelled under the Standard Formula:

- **Reserve risk –** the risk of the best estimate claims deteriorating i.e. that the reserves are insufficient to cover the unpaid claims that have already occurred
- **Premium risk –** the risk that premiums received for the business written in the following 12 months will not be sufficient to cover future claims and related costs from that business
- **Catastrophe risk –** the risk of claims arising due to natural catastrophes such as floods, windstorms and earthquakes and man-made catastrophes such as fire or aggregation of liability claims
- **Market risk –** the risk of adverse changes in net asset values as a result of movements in market risk variables such as interest rates, exchange rates, equity market values etc. It also includes the

exposure to investment credit risk (the risk of default or adverse movements in credit ratings of the assets)

- **Counterparty default risk –** the risk of losses due to default or downgrade of reinsurers or due to non-payment of receivables from third parties
- **Operational risk –** the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events
- **Loss absorbing capacity of deferred taxes ("LACDT") –** a deduction from the SCR to reflect that a deferred tax asset may be allowable following a severe 1-in-200 year loss.

Appropriateness of the Standard Formula for calculating AIUK's regulatory capital requirements

8.9 There is no prior approval process with the PRA or other regulators before an entity is permitted to use the Standard Formula to calculate its Solvency II SCR and MCR. The Standard Formula is designed to be used by most firms, although firms must be able to demonstrate that it is appropriate, and that any deviations from the assumptions underlying the Standard Formula are not significant.

8.10 AIUK's ORSA includes an assessment of the appropriateness of the Standard Formula for its business mix and risk profile and considers whether the Standard Formula:

- Adequately captures all of the material risks that are identified in AIUK's risk registers
- Calculates results that are inconsistent with those under AIUK's stress and scenario testing analysis
- Calculates results that are lower than the PRA's Early Warning Indicators ("EWI").

8.11 AIUK is a well-diversified insurer which, on the whole, aligns with the over-arching principles used in the calibration of the Standard Formula parameters, although I do note some specific exceptions below. In aggregate, I consider AIUK's regulatory capital requirements to be appropriate since:

- AIUK's stress and scenario testing analysis indicates that the Standard Formula provides a sufficient buffer across all of the risk categories considered apart from Man-Made Catastrophe Risk where the Standard Formula calculates a slightly lower capital requirement in respect of this underlying risk driver. However, the Standard Formula calculated a higher loss in respect of each of the other risk drivers that were considered in AIUK's stress testing. Given the magnitude of the difference, I do not consider the difference in respect of Man-Made Catastrophe Risk to be material.
- AIUK has assessed whether the Standard Formula adequately captures all of the material risks that are identified in AIUK's risk registers. A number of additional risks were identified in the risk registers however I agree with AIUK's conclusion that these risks are of a low materiality.

AIUK's Solvency II Own Funds

8.12 AIUK had £75.7m of unrestricted Tier 1 Own Funds as at 31 December 2019. As per Solvency II regulations, Tier 1 Own Funds can be recognised in full to meet the SCR and the MCR capital requirements. The full value of the Tier 1 Own Funds is made up of ordinary share capital and the reconciliation reserve and is classed as unrestricted Tier 1 capital.

8.13 As at 31 December 2019, AIUK had £8.0m of Tier 2 Own Funds. Under Solvency II rules, insurers may rely on Tier 2 Own Funds up lo a limit of 50% of the SCR to meet their regulatory capital requirement. Tier 2 Own Funds can also be partially recognised to meet the MCR up to a limit of 20% of the MCR.

8.14 As at 31 December 2019, AIUK did not hold any Tier 3 Own Funds.

8.15 The table below shows the breakdown of AIUK's Eligible Own Funds to meet the SCR

Table 8.1: AIUK's Eligible Own Funds at 31 December 2019

£m	
Tier 1	75.7
Tier 2	8.0
Tier 3	0.0
Total Eligible Own Funds	**83.7**

8.16 I have reviewed AIUK's allocation of Own Funds to the tiers and I have not identified any areas that are out of line with regulatory requirements. I also observe that the significant majority of Eligible Own Funds are Tier 1, which is the highest tier of Own Funds.

AIUK's approach to calculating its economic capital requirements and economic own funds

8.17 AIUK's economic capital requirement is calculated based on the Standard Formula SCR by applying an adjustment in respect of its holding in its subsidiary AEIS. Under this approach, the assets of the subsidiary company are treated as though they are held directly by AIUK. In addition, intragroup assets held by AEIS are also valued as though they are held directly by AIUK. AIUK has informed me that the main impact of this adjustment is a reduction in the value of one asset held by AEIS, namely, an intragroup loan issued by AEIS to Arch Holdings U.K. Ltd, which is a sister company within the Arch Group.

8.18 The adjustment in paragraph 8.17 above reduced AIUK's Eligible Own Funds as at 31 December 2019, not adjusted for the impact of COVID-19, by £30.0m from £83.7m to £53.7m and resulted in a corresponding reduction in the SCR of £3.1m from £46.8m to £43.7m. As discussed in paragraph 8.17 above, the reduction in AIUK's own funds reflects a reduction in the value of an intragroup loan issued by AEIS to Arch Holdings U.K. Ltd . As this adjustment results in a reduction in the value of AIUK's investments, applying the Solvency II Standard Formula to the adjusted investment portfolio results in a reduction in market risk component of the Standard Formula SCR. In particular, under AIUK's regulatory basis, AEIS is treated as a participation and the capital requirement for AIUK's holding in AEIS is modelled as equity risk. By comparison, under the economic basis, the individual assets held by AEIS are modelled directly by applying the Solvency II Standard Formula rules to these assets.

8.19 Following the adjustments discussed in paragraphs 8.17 and 8.18 above, AIUK's SCR coverage ratio as at 31 December 2019 reduced from 178.9% to 122.9%. This is as a result of the Own Funds reducing by more than the SCR, as outlined in paragraph 8.18.

8.20 I note that AIUK's economic capital requirement is, like its SCR, still on a one-year basis as opposed to an ultimate basis. I have assessed the impact of moving to an ultimate basis on the capital coverage ratios in my stress testing analysis, which I describe in paragraphs 8.64 to 8.115.

8.21 Although the economic approach results in a lower SCR than the regulatory approach, the own funds are also lower on the economic approach, resulting in a lower SCR coverage ratio. Allowing for this, the economic approach is the more conservative of the two measures of capital adequacy.

8.22 I conduct my own stress testing in paragraphs 8.64 to 8.115, to assess the likelihood of AIUK not being able to meet its liabilities over the course of the run-off of the liabilities following the Scheme.

Reasonableness of regulatory and economic capital calculations

8.23 I note that, whilst I have considered the methodology and key assumptions for each element described above, I have not reviewed the calculations in detail. However, I have considered the output of the Standard Formula calculation based on both a regulatory basis and AIUK's economic basis, as discussed in paragraph 8.17, and I have not identified any reason to believe that the calculated SCR materially understates or overstates the regulatory capital required by AIUK, or that AIUK's economic capital requirement is an unreasonable estimate of the capital it requires on a one-year basis.

8.24 I have reviewed the CVs of the individuals at AIUK who were responsible for calculating the regulatory capital requirement and economic capital requirement. Based on these and my interactions with those individuals, I am satisfied that the individuals at AIUK who were responsible for these calculations have the necessary experience and expertise to undertake this work and for me to rely on their work for the following reasons:

- The CVs reviewed showed relevant experience in general insurance and actuarial roles, with adequate capital modelling and Solvency II standard formula experience
- The CVs of key team members reviewed showed that these individuals had worked at AIUK for a number of years.

AIUK's capital strategy

8.25 I understand from AIUK that it aims to maintain a minimum capital coverage of both its regulatory and economic capital requirements of 120%, and that, if AIUK's capital drops to below 110%, then it will take appropriate actions to remediate this.

8.26 These actions are included in AIUK's capital management plan which is monitored and reviewed annually by the Board.

8.27 A key source of capital available to AIUK that can be realised if necessary is capital injection or a capital loan from other ACGL entities. I note from AIUK's Solvency and Financial Condition Reports for the years ending 2018 and 20219 that ACGL entities have in the last two years provided capital to AIUK at short notice on a number of occasions. AIUK's 2018 and 2019 Solvency and Financial Condition Reports show that the following capital injections were received by AIUK from other ACGL entities in the last two years:

- In 2019, AIUK received a £10.0m capital contribution from its parent company, Arch Reinsurance Europe Underwriting dac, to support the new business generated as result of AIUK's acquisition of the Arch UK Regional Division
- Also in 2019, AIUK received a loan of £8.0 million from Arch Capital Finance (Ireland) Limited to support growth in Arch UK Regional Division
- In 2018, AIUK received £32.5m of additional capital from Arch Reinsurance Europe Underwriting dac, , to support the continued underwriting of the Arch UK Regional Division. Subsequent to this, in 2019, AIUK contributed £25.5m in 2019 to its subsidiary AEIS for the same purpose.

8.28 In my opinion, the capital transfers above demonstrate that ACGL is a viable and tested source of additional capital for AIUK.

8.29 In addition to the above, AIUK has informed me that external sources of capital, such as private equity and third-party capital will also be considered if this is required.

8.30 AIUK has also outlined internal management actions that may be taken such as the short-term use of reinsurance, the sale of certain books of business and adjustments to its investment strategy. In more severe cases, actions include the restriction or discontinuation of certain lines of business, product redesign and material repricing.

Impact of the Scheme on AIUK’s balance sheets and coverage ratios

Impact on a GAAP basis at 31 December 2019

8.31 The table below shows the simplified GAAP balance sheets of AIUK at 31 December 2019, both before and after the Scheme and before considering the impact of COVID-19. These balance sheets have been prepared by AIUK on the basis that the Scheme had become effective at 31 December 2019.

Table 8.2: AIUK’s GAAP balance sheets at 31 December 2019, before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
Assets:			
Investments	104.2	(23.5)	80.7
Cash	-	-	-
Reinsurers' share of technical provisions	579.5	(207.4)	372.1
Deposits with ceding undertakings	-	-	-
Debtors	72.2	(9.6)	62.6
Other assets	47.8	(1.0)	46.8
Prepayments and accrued income	35.0	(7.0)	28.0
Total assets	**838.8**	**(248.5)**	**590.2**
Liabilities:			
Technical provisions	639.0	(225.6)	413.3
Creditors	77.8	(5.0)	72.8
Accruals and deferred income	41.7	(8.7)	33.0
Total liabilities	**758.4**	**(239.2)**	**519.2**
Net assets	**80.3**	**(9.3)**	**71.0**

8.32 The main changes in the balance sheet, as a result of the Scheme, include a reduction in technical provisions of £225.6m which is partly offset by a decrease in reinsurers’ share of technical provisions of £207.4m. The resulting reduction in net reserves is £18.2m.

Impact on a Solvency II basis at 31 December 2019

8.33 The table below shows the simplified Solvency II balance sheets and SCR coverage ratios of AIUK at 31 December 2019, both before and after the Scheme and before considering the impact of COVID-19. These balance sheets and capital requirements have been prepared by AIUK on the basis that the Scheme had become effective at 31 December 2019.

Table 8.3: AIUK's Solvency II balance sheets and SCR coverage ratios at 31 December 2019, before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
Assets:			
Investments	107.7	(23.5)	84.3
Cash	30.3	0.0	30.3
Reinsurers' share of technical provisions	485.9	(182.5)	303.4
Insurance and other receivables	48.8	(5.1)	43.7
Other assets	18.7	1.0	19.7
Total assets	**691.4**	**(210.1)**	**481.4**
Liabilities:			
Gross best estimate technical provisions	558.3	(203.6)	354.7
Risk margin	5.1	(1.5)	3.6
Other liabilities	52.3	(5.0)	47.3
Total liabilities	**615.7**	**(210.1)**	**405.6**
Own Funds:			
Net assets	75.7	0.0	75.7
Subordinated liabilities	8.0	0.0	8.0
Total Eligible Own Funds to meet SCR	**83.7**	**0.0**	**83.7**
SCR Coverage Ratio:			
Solvency Capital Requirement (SCR)	46.8	(8.9)	37.9
Eligible Own Funds	83.7	0.0	83.7
SCR coverage ratio	**178.9%**	**41.9%**	**220.8%**
MCR Coverage Ratio			
Minimum Capital Requirement (MCR)	11.7	(2.2)	9.5
Eligible Own Funds	83.7	0.0	83.7
MCR coverage ratio	**716.2%**	**164.2%**	**880.4%**

8.34 The main changes in the balance sheet, as a result of the Scheme, include a reduction in gross best estimate technical provisions of £203.6m which is partly offset by a decrease in reinsurers' share of technical provisions of £182.5m. The resulting change in net technical provisions is £21.1m.

8.35 The Scheme would result in a 41.9% increase in AIUK's SCR coverage ratio from 178.9% to 220.8% and a 164.2% increase in its MCR coverage ratio from 716.2% to 880.4%. This is due to the fact that AIUK's SCR and MCR decrease following the Scheme, mainly driven by a reduction in its net technical provisions, however, the Scheme does not result in a reduction in AIUK's Eligible Own Funds.

8.36 Insurance and other receivables in the table above includes insurance, intermediaries, reinsurance and trade receivables.

8.37 Other liabilities includes trade payables, subordinated liabilities and any other liabilities, not shown elsewhere on the balance sheet.

Projected SCR and Own Funds on the Effective Date and adjustment for COVID-19 event

8.38 In addition to the SCR and Own Funds as at 31 December 2019, AIUK has also projected what its Own Funds and SCR would be at the Effective Date. Separate projections were also carried out assuming that the Scheme is in place at the Effective Date and the Scheme is not in place at the Effective Date.

8.39 To estimate the SCR at the Effective Date, AIUK has projected what the inputs for its Solvency II standard formula calculation would be at the Effective Date. This included the projection of AIUK's Solvency II technical provisions, Solvency II balance sheet, premium volumes and mix for the twelve-month period following the Effective Date and the value and mix of AIUK's investment portfolio at the Effective Date.

8.40 As AIUK performed the above analysis prior to the COVID-19 event, its projections have not taken the impact of this event into account. I have however adjusted AIUK's Own Funds and SCR projections at the Effective Date to take into account the impact of the COVID-19 event. For this purpose, I have relied on AIUK's quantitative assessment of the impact of the COVID-19 on its net best estimate reserves, investment portfolio and SCR. I have reviewed the assumptions and methodology underlying AIUK's quantitative assessments above and believe them to be reasonable for the following reasons:

- The assessments have appropriately considered AIUK's insurance portfolio and the expected impact of COVID-19 on each of AIUK's main classes of business
- The assessments appropriately considered AIUK's investment portfolio and the expected impact of COVID-19 on the value of its investments
- The assessments have appropriately considered AIUK's credit risk counterparties and the expected impact of COVID-19 on its bad debt
- The assessments have appropriately considered the impact of changes in the external environment on AIUK's risk profile, business and operations.

8.41 In addition to AIUK's quantitative assessment, AIUK has also informed me that it expects a £15.1m reduction in gross written premium for the 200 underwriting year volume compared to what it had originally assumed in its business plan. I have therefore calculated an additional amount representing AIUK's loss of profits arising as a result of this reduction in premium volume.

8.42 Based on AIUK's quantitative assessment discussed in paragraph 8.39 above, and my calculation of the loss of profits resulting from the expected reduction in premium volume, the adjustments I applied to AIUK's projected Own Funds are summarised below:

- AIUK's best estimate of the net loss from the COVID-19 event is a £4.7m deterioration in its net best estimate reserves. I have assumed that there will be a corresponding £4.7m deterioration in AIUK's Solvency II net technical provisions and have reduced the Own Funds by an amount equal to this deterioration.
- AIUK assessed that there was a 3.1% deterioration in the value of its investment portfolio. I have assumed that there will be a corresponding 3.1% deterioration in the projected value of the investment portfolio at the Effective Date and have reduced the Own Funds by an amount equal to this deterioration.
- I have calculated that there will be a £3.5m reduction in AIUK's profits in 2020, in comparison to its original forecast, as a result of a £15.1m reduction in premium volumes.
- AIUK has informed me that it has not experienced any credit risk losses to date as a result of this event. I have, therefore, made no adjustments in this risk area. AIUK's credit risk is primarily being driven by reinsurance counterparty risk. I discuss AIUK's reinsurance counterparties in paragraph 8.49 below. Based on my assessment of the strength of AIUK's reinsurance counterparties, I believe that not including an adjustment for credit risk is reasonable.
- AIUK has informed me that it has not experienced any operational risk losses to date as a result of this event. I have, therefore, made no adjustments in this risk area.

8.43 The adjustment that I have applied in respect of Solvency II net technical provisions is a simplification as there would in addition be an impact on other components of the Solvency II technical provisions such as the discounting allowance and risk margin. However, based on my experience, I believe the most material impact on the overall net technical provisions will be in respect of the net best estimate reserves and that the impact on other components is likely to be of a secondary order. For this reason and because, as I discussed in paragraph 7.70, any estimate of the COVID-19 loss at this time is subject to considerable uncertainty, I believe that the adjustment I have applied is appropriate.

8.44 The table below summarises AIUK's projected Own Funds at the Effective Date, prior to and following the Scheme. Also shown in the table is the adjustments which I have applied to AIUK's projections in respect of the COVID-19 loss event.

Table 8.4: AIUK's projected Own Funds at 31 December 2020, before and after the Scheme

£m	Before Scheme	After Scheme
Eligible Own Funds at Effective Date (before adjustment)	85.7	85.7
Deterioration in net reserves	-4.7	-4.7
Investment losses	-3.5	-3.5
Increase in bad debt	-	-
Expense increase	-	-
Loss due to business volume reduction	-3.5	-3.5
Eligible Own Funds at Effective Date (adjusted for COVID-19)	**74.0**	**74.0**

8.45 The table below summarises AIUK's projected SCR at the Effective Date prior to and following the Scheme. Also shown in the table is the adjustment which I have applied to AIUK's projections in respect of the COVID-19 loss event.

Table 8.5: AIUK's projected SCR at 31 December 2020, before and after the Scheme

£m	Before Scheme	After Scheme
SCR at Effective Date (before adjustment)	**45.9**	**40.1**
Adjustments to SCR in respect of:		
Reserve risk	1.0	1.0
Underwriting risk	-0.4	-0.4
Market risk – investments	0.1	0.1
Market risk - exchange rates	1.5	1.5
Credit risk	0.7	0.7
Operational risk	0.2	0.2
SCR at Effective Date (adjusted for COVID-19)	**49.0**	**43.2**

8.46 It can be seen in the above tables that the adjustments for COVD-19 are the same both prior to and following the Scheme. This is because, as discussed in paragraph 7.74, AIUK has informed me that there is no substantial exposure to COVID-19 within the Transferring Portfolio.

8.47 From Table 8.4, I have estimated that the COVID-19 loss event would result in a £3.1m increase in AIUK's projected Solvency II SCR as at 31 December 2020.

8.48 The reserve risk, underwriting risk and operational risk impacts in the table above were calculated by AIUK. I have reviewed the assumptions and methodology underlying AIUK's estimate of the impact on the SCR and believe them to be reasonable for the reasons I discussed in paragraph 8.40.

8.49 AIUK has informed me that it has not calculated an adjustment to its SCR in respect of credit risk. It has further informed me that this is for the following reasons:

- AIUK's credit risk is primarily being driven by reinsurance counterparty risk. AIUK's largest reinsurance counterparty is Arch Reinsurance Ltd. under the IQS. As discussed in paragraph 9.22, the IQS is fully collateralised and the risk of Arch Reinsurance Ltd. defaulting on reinsurance recoveries due to AIUK is therefore, in my view, remote.
- In respect of AIUK's remaining reinsurance counterparty exposures, the vast majority of AIUK's external reinsurers have a credit rating of A and above (approximately 99.97% of AIUK's reinsurance recoverables on a Solvency II basis as at 31 December 2019). I consider that reinsurers with such ratings are unlikely to default.

8.50 I have however increased AIUK's SCR in respect of credit risk to account for the possibility of there being rating downgrades on AIUK's reinsurance counterparties brought about by a prolonged challenging general economic environment due to COVID-19. I calculated the increase in AIUK's credit risk SCR by repeating the Solvency II standard formula SCR calculation for AIUK but assuming that the credit ratings for approximately a quarter (by volume of recovery) of AIUK's reinsurance counterparties are downgraded by one rating category.

8.51 From Table 8.4, it can be seen that there was a reduction in the value of AIUK’s investment portfolio as a result of the COVID-19 loss event. The reduction in the value of the investment portfolio would result in a corresponding reduction in the SCR calculated under the Solvency II standard formula. However, AIUK has not calculated an adjustment to reduce its SCR in respect of this.

8.52 I have also recognised that there is a possibility of there being rating downgrades on AIUK’s investments driven by a prolonged poor general economic environment. I calculated the resulting increase in AIUK’s market risk SCR by repeating the Solvency II standard formula SCR calculation for AIUK but assuming the credit ratings for approximately half (by market value) of the AIUK’s fixed income investments (other than sovereign debt) are downgraded by one rating category.

8.53 I will review all of the adjustments in Table 8.4 and 8.5 above in the light of the latest available information on COVID-19 and provide an update to these figures in my Supplementary Report.

Impact on a Solvency II basis at the Effective Date, 31 December 2020

8.54 As discussed in paragraphs 8.38 to 8.39, AIUK has projected its balance sheet as at 31 December 2019 to provide an estimate of what it expects the equivalent figures to be as at the Effective Date, 31 December 2020.

8.55 The table below shows the simplified Solvency II balance sheets, SCR coverage ratios and ECR coverage ratios of AIUK at the Effective Date, 31 December 2020, both before and after the Scheme. The tables shown below include the adjustments in respect of the COVID-19 loss I discuss in paragraphs 8.41 to 8.46.

Table 8.6: AIUK's Solvency II balance sheets, SCR coverage ratios and ECR coverage ratios at 31 December 2020,

before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
Assets:			
Investments	109.6	(11.1)	98.5
Cash	30.0	0.0	30.0
Reinsurers' share of technical provisions	472.1	(139.4)	332.7
Insurance and other receivables	51.2	(4.5)	46.7
Other assets	11.6	0.0	11.6
Total assets	**674.5**	**(155.0)**	**519.5**
Liabilities:			
Gross best estimate technical provisions	548.1	(152.2)	395.9
Risk margin	5.5	(1.4)	4.1
Other liabilities	54.9	(1.5)	53.5
Total liabilities	**608.6**	**(155.0)**	**453.5**
Own Funds:			
Net assets	66.0	0.0	66.0
Subordinated liabilities	8.0	0.0	8.0
Total Eligible Own Funds to meet SCR	**74.0**	**0.0**	**74.0**
SCR Coverage Ratio:			
Solvency Capital Requirement (SCR)	49.0	(5.8)	43.2
Eligible Own Funds	74.0	(0.0)	74.0
SCR coverage ratio	**150.8%**	**20.3%**	**171.1%**
AIUK Economic Basis Own Funds:			
Net assets	36.0	0.0	6.0
Subordinated liabilities	8.0	0.0	8.0
Total Eligible Own Funds to meet ECR	**44.0**	**0.0**	**44.0**
AIUK Economic Basis Coverage Ratio:			
Economic Capital Requirement (ECR)	42.8	-5.8	37.0
Own Funds to meet ECR	55.7	0.0	55.7
ECR coverage ratio	**130.0%**	**20.4%**	**150.4%**

8.56 At the Effective Date, the main impact on AIUK's projected Solvency II balance sheet, as a result of the Scheme, is a reduction in gross best estimate technical provisions of £152.2m which is partly offset by a decrease in reinsurers' share of technical provisions of £139.4m. The resulting change in net technical provisions is £12.8m.

8.57 At the Effective Date, the projected impact of the Scheme on AIUK's SCR coverage ratio is a 20.3% increase from 150.8% to 171.1%%. The increase in the SCR coverage ratio is due to the fact that AIUK's SCR following the Scheme, mainly driven by a reduction in its net technical provisions, however, the Scheme does not result in a reduction in AIUK's Eligible Own Funds.

8.58 On AIUK's economic basis, the projected impact of the Scheme on AIUK's ECR coverage ratio is a 20.4% increase from 130.0% to 150.4%. The increase in AIUK's ECR coverage ratio is due to same underlying reasons as the increase AIUK's SCR coverage ratio discussed in paragraph 8.57.

8.59 The impact of the transfer on AIUK's capital figures are discussed further detail in Section 9.

ORSA

8.60 I have been provided with a copy of AIUK's most recent ORSA report which includes a forward-looking assessment of its risk profile and regulatory and economic capital requirements. The ORSA document is dated 27 December 2019 and has been approved by AIUK's Board.

Stress tests within the ORSA report

8.61 AIUK has considered various stress and scenario tests within its ORSA report to test the robustness of its capital position. The stress and scenario testing covers a wide range of risks that AIUK is exposed to such as a world economic slowdown, the loss of a senior underwriter and a natural catastrophe. I have reviewed the approach undertaken in relation to these stresses and consider the approach and key assumptions to be reasonable for the following reasons:

- The parameters underlying AIUK's analysis are reasonable and have been applied appropriately
- AIUK has considered 24 stress tests
- The stress tests considered have taken into account AIUK's current risk profile and the key risks that may affect it from within its portfolio or from external environments or large events
- In addition to the 24 stress tests above, AIUK also performed a number of reverse stress tests, which considered the impact from severe events.

8.62 The vast majority of the stress tests undertaken would not reduce AIUK's SCR coverage ratio below 120%. The only stress test that may have reduced AIUK's SCR coverage ratio below 120% was the 'No Brexit' scenario, in which EU business would be included in AIUK instead of AIEU. At the time of writing this report, this scenario is no longer under consideration given that the United Kingdom withdrew from the European Union on the 31 January 2020.

8.63 AIUK's ORSA was however performed prior to the COVID-19 event and AIUK did not consider the impact of this event in its stress and scenario testing. In order to assess the potential impact of the COVID-19 event on AIUK's SCR coverage ratio, I have considered this in my own stress testing. I discuss my analysis and my estimate of the impact from the COVID-19 event on AIUK's SCR coverage ratio, under a worst realistic case scenario, in paragraphs 8.88 to 8.93.

Stress testing

8.64 In order to test the sufficiency of AIUK's Own Funds and to support my conclusions, I have undertaken a number of high-level stress tests as set out in the paragraphs below.

8.65 I have assessed the resilience of AIUK's capital position against a number of scenarios. I have selected the scenarios below based on my review of AIUK's business structure and risk profile. The scenarios that I have selected represent, in my opinion, the risks that could most significantly impact AIUK's financial and capital strength. The scenarios I have considered in my stress tests are as follows:

- A deterioration of AIUK's net best estimate technical provisions
- A deterioration of AIUK's expected loss ratio for unexpired and new business
- Financial losses from significant catastrophe events
- Financial losses from significant loss event affecting AIUK's liability classes of business
- Further financial losses arising on the COVID-19 event
- A reduction in the reinsurance asset as a result of default of a reinsurer
- A deterioration in the value of AIUK's investment portfolio.

8.66 In addition, I have also considered the following combinations of the above stress tests occurring simultaneously:

- Financial losses from a significant catastrophe event followed by reinsurer defaults
- A deterioration of the net best estimate technical provisions and a significant loss event affecting liability classes of business

8.67 I have estimated likelihoods for the various levels of deterioration in AIUK's net technical provisions that I have considered in my scenario testing. I have estimated this using AIUK's projection of its technical provisions and the corresponding assumptions from the Solvency II Standard Formula. The Solvency II Standard Formula reserve deterioration assumptions have been calibrated to calculate the risk of a reserve deterioration over a twelve month period ("One Year Basis"), in order to assess the risk over a longer time horizon, I have increased the Solvency II Standard Formula reserve deterioration assumptions to allow for the additional risk that would arise up to the time when all cashflows in respect of AIUK's technical provisions have been settled ("Ultimate Basis").

8.68 In particular, I assumed that the Solvency II Standard Formula reserve deterioration assumptions are on a One Year Basis and I calculated a corresponding assumption for each Solvency II line of business on an Ultimate Basis as follows:

- Assuming that the reserve deterioration on a One Year Basis is 75% of that under an Ultimate Basis for the following lines of business:
  - Direct and Proportional Fire & Other Damage to Property
  - Direct and Proportional Credit & Suretyship
  - Direct and Proportional Legal Expenses
  - Direct and Proportional Assistance
  - Direct and Proportional Medical Expenses
  - Direct and Proportional Income Protection
- Assuming that the reserve deterioration on a One Year Basis is 50% of that under an Ultimate Basis for the following lines of business:

- Direct and Proportional Motor Vehicle Liability
- Direct and Proportional Other Motor
- Direct and Proportional Marine, Aviation and Transportation
- Non-Proportional Marine, Aviation and Transportation Reinsurance
- Non-Proportional Property Reinsurance
- Non-Proportional Health Reinsurance

- Assuming that the reserve deterioration on a One Year Basis is 25% of that under an Ultimate Basis for the following lines of business:
  - Direct and Proportional Workers' Compensation
  - Direct and Proportional General Liability
  - Direct and Proportional Miscellaneous Financial Loss
  - Non-Proportional Casualty Reinsurance

8.69 For the purpose of these stress tests, I have considered AIUK's projected financial position on the Effective Date following the Scheme. For the reasons I discussed in paragraphs 8.40 to 8.41, I have adjusted AIUK's projected regulatory capital requirement and own funds following at the Effective Date to take into account losses arising from the COVID-19 event.

8.70 It follows that I have performed the stress testing on the basis that AIUK's starting financial position at the Effective Date is as follows:

- SCR = £43.2m
- Eligible Own Funds = £74.0m
- Excess of Own Funds over the SCR = £30.7m
- SCR coverage ratio = 171.1%

Deterioration of AIUK's net best estimate technical provisions

8.71 AIUK's projected net best estimate technical provisions following the Scheme on the Effective Date and including my adjustment for reserve deterioration due to the COVID-19 event are £63.3m. I have been informed by AIUK that its projection of the net best estimate technical provisions is on a best estimate basis and that it allows for the impact of any material events, other than the COVID-19 event which I have applied an adjustment for, between the time of my analysis and the Effective Date that are known to AIUK and may have a material impact on AIUK's net technical provisions. I therefore consider £63.3m to be a fair proxy for the actual net best estimate technical provisions at the Effective Date following the Scheme.

8.72 In order to reduce its SCR coverage ratio from 171.1% to 100% or below, AIUK would need to experience a deterioration in its net best estimate technical provisions in the region of £30.7m (48.6%) of its net best estimate technical provisions, from £63.3m to £94.0m. I have estimated that there is a likelihood of less than 0.39% that the net best estimate provisions will deteriorate by £30.7m. I consider a deterioration of this magnitude to be remote.

8.73 Furthermore, in order for AIUK's assets to fall beneath its liabilities, it would need to experience a deterioration in the region of £74.0m (116.9%) in its net best estimate technical provisions from £63.3m to £137.3m. I have estimated that there is a likelihood of less than 0.001% that the net best estimate provisions will deteriorate by £74.0m. I therefore consider a deterioration of this magnitude to be remote.

8.74 In reaching this conclusion, I have considered the following:

- As discussed in paragraph 7.36, I consider AIUK's estimate of its Solvency II best estimate technical provisions to be within a reasonable range of estimates
- As discussed in paragraph 8.43, I have adjusted AIUK's Own Funds and its net technical provisions to include an allowance for the COVID-19 loss on a best estimate basis before applying this stress test. The deterioration considered in this stress test represents losses that occur in addition to significant investment losses arising from the COVID-19 event.
- My approach to the estimation of the likelihood is based on an extrapolation of the assumptions underlying the Solvency II Standard Formula calculation. Based on an assessment of the appropriateness of the assumptions underlying the Solvency II Standard Formula for AIUK's business and risk profile, which is described in paragraphs 8.9 to 8.11, I am satisfied that I am able to place reliance on the assumptions underlying the Solvency II Standard Formula for this estimation.
- AIUK has a well-diversified portfolio of insurance liabilities and therefore a 48.6% deterioration would need to correspond to a far more severe deterioration in a small number of classes, either simultaneously or gradually over time.

Deterioration in expected loss ratio for unexpired and new business

8.75 AIUK expected underwriting profit for the 2021 underwriting year is projected to be £4.7m before the IQS and £5.2m after the IQS.

8.76 In order to reduce its SCR coverage ratio to 100% or below, AIUK would need to experience a deterioration in the region of £35.9m of its underwriting profit, from a profit of £5.2m to a loss of £30.7. The corresponding deterioration required in respect of AIUK's net loss ratio is 88.8% from 60.2% to 149.0% and the corresponding change in the net combined ratio is from 78.5% to 167.3%.

8.77 Furthermore, in order for AIUK's assets to fall beneath its liabilities, it would need to experience a deterioration in the region of £79.2m in its underwriting profit, from a profit of £5.2m to a loss of £74.0m. The corresponding deterioration required in respect of AIUK's net loss ratio is 195.5% from 60.2% to 255.7% and the corresponding change in the net combined ratio is from 78.5% to 274.0%.

8.78 Using the assumptions underlying the Solvency II Standard Formula and AIUK's expectation of its business mix and volume in 2021, I have estimated that there is a 0.5% likelihood that AIUK's losses will exceed £21.5m over a one-year time horizon. The likelihood that losses will exceed £30.7m is therefore significantly lower than 0.5%, and the likelihood that losses will exceed £74.0m is lower still. I therefore consider the likelihood of a deterioration of £74.0m to be remote.

8.79 In reaching this conclusion, I have considered the following:

- Based on an assessment of the appropriateness of the assumptions underlying the Solvency II Standard Formula for AIUK's business and risk profile, described in paragraphs 8.9 to 8.11, I am satisfied that I am able to place reliance on the assumptions underlying the Solvency II standard formula for this estimation.
- As discussed in paragraph 8.43, I have adjusted AIUK's Own Funds to include an allowance for the COVID-19 loss on a best estimate basis before applying this stress test. The deterioration considered in this stress test represents losses that occur in addition to the COVID-19 loss.
- The loss ratios that AIUK has used to derive the projected underwriting profit in 2021 of £4.7m that I described in paragraph 8.75 do not appear unreasonable in comparison to its historical experience
- AIUK has a well-diversified portfolio of insurance liabilities and therefore a 88.8% deterioration in its net loss ratio would need to correspond to a far more severe deterioration in a small number of classes, either simultaneously or gradually over time.

Financial losses from significant catastrophe events

8.80 This stress test assumes that AIUK experiences losses from a significant natural catastrophe event during 2021. The severity of this natural catastrophe event was assessed by AIUK to be equivalent to a 1-in-250 year event and results in a gross loss of £41.3m for AIUK.

8.81 AIUK purchases significant reinsurance cover in respect of natural catastrophes, and AIUK has estimated that the corresponding net loss that it would experience following this event will be £13.8m excluding the recoveries under the IQS and £2.1m including recoveries from the IQS. The resulting deterioration in AIUK's Eligible Own Funds from this event is therefore £2.1m.

8.82 Given that this scenario test has been constructed based on a 1-in-250 year event, there is a 0.4% likelihood that this scenario would occur. I therefore consider such an occurrence to be remote. I note that, even in this scenario, AIUK is expected to maintain a SCR coverage ratio substantially in excess of 100% and that it would require a net loss 14.6 times higher than this (i.e. a net loss of £30.7m) to reduce AIUK's SCR coverage ratio to 100%.

8.83 In addition, it would require a net loss 35.2 times higher (i.e. a loss of £74.0m) for AIUK's assets to fall below its liabilities. I consider the likelihood of a loss of £74.0m arising from a natural catastrophe event to be remote.

Financial losses from a significant loss event affecting AIUK's liability classes of business

8.84 This stress test assumes that AIUK experiences a series of severe events during 2021 which result in significant increase in insurance claims in its Directors & Officers, Financial Institutions, Professional Liability, and Casualty classes of business. The severity of this event is assessed by AIUK to be equivalent to a 1-in-200 year event and results in a gross loss of £56.7m for AIUK.

8.85 AIUK has estimated that the corresponding net loss that it would experience following this event will be £37.8m excluding the recoveries under the IQS and £5.7m after allowing for recoveries from the IQS. The resulting deterioration in AIUK's Eligible Own Funds from this event is therefore £5.7m.

8.86 AIUK has estimated that there is a 0.5% likelihood that this scenario would occur. I therefore consider such an occurrence to be remote. I note that, even in this scenario, AIUK is expected to maintain a SCR coverage ratio substantially in excess of 100% and that it would require a net loss 5.4 times higher than this (i.e. a net loss of £30.7m) to reduce AIUK's SCR coverage ratio to 100%.

8.87 In addition, it would require a net loss 13.0 times higher (i.e. a net loss of £74.0m) for AIUK's assets to fall below its liabilities. I consider the likelihood of a loss of £74.0m arising from a loss event affecting AIUK's liability classes of business to be remote.

Deterioration in AIUK's net reserves for the COVID-19 loss event

8.88 I have calculated a very pessimistic but plausible loss that could follow a new pandemic event or a worsening or second wave of the current COVID-19 pandemic event. I consider the impact of this below.

8.89 I have calculated each of the loss components in this scenario based on AIUK's risk profile, business mix and investment portfolio following the Scheme. To calculate the property and liability losses for this scenario, I used the assumptions underlying the Solvency II Standard Formula calculation, applying the same methodology that I discuss in paragraphs 8.67 and 8.68. Since the Solvency II SCR is on a one-year basis (i.e., it considers the risk over a time period of one year), I included an adjustment in my calculations to allow for the additional risk that would arise up to the time when all cashflows have been settled.

8.90 I have assumed the following losses are assumed under this scenario:

- There is a significant increase in the claims on AIUK's property classes of business. The severity of this event is assessed to be equivalent to a 1-in-200 year event and results in a loss of £13.3m net of reinsurance.
- There is a significant increase in the claims on AIUK's liability classes of business. The severity of this event is assessed to be equivalent to a 1-in-200 year event and results in a loss of £7.3m net of reinsurance.
- There is a 10% reduction in AIUK's written premium volume in the following trading year. This reduces AIUK's ability to offset its operational costs and leads to a £8.3m net underwriting loss.
- There is a 300 basis point increase in interest rates which results in a £2.3m deterioration in the market value of AIUK's investment portfolio.
- There is a 25.0% deterioration in the Sterling to US Dollar and Euro exchange rates. This reduces the Sterling value of its Own Funds by £1.8m.

8.91 In my view, the above represents a very pessimistic but plausible outcome for AIUK.

8.92 Under this scenario, AIUK's Own Funds fall by approximately £32.9m million in total, which would reduce AIUK's SCR coverage ratio to 95.1%. However, the value of its assets would still exceed its liabilities.

8.93 As the scenario above represents a very pessimistic but plausible outcome for AIUK and as AIUK's assets remain higher than its liabilities under this scenario, my opinion is that I consider that AIUK will have sufficient assets to meet its liabilities following a reasonably foreseeable worsening of the COVID-19 global pandemic or following a new reasonably foreseeable global pandemic.

Reduction in the reinsurance asset as a result of default by reinsurers

8.94 AIUK's projected net best estimate of the reinsurers' share of technical provisions at the Effective Date, and including my adjustment for additional losses due to COVID-19, amounts to £332.7m. In order to reduce its SCR coverage ratio to 100% or below, AIUK would need to experience a reduction in the value of its reinsurance asset in the region of £30.7m, or 9.2%, as a result of default by reinsurers. In addition, AIUK would need to experience a reduction in the value of its reinsurance recoveries in the region of £74.0m, or 22.2%, for its assets to fall below its liabilities.

8.95 As discussed in paragraphs 5.15 to 5.18, AIUK benefits from substantial reinsurance from the Arch Reinsurance Ltd. (at 31 December 2019, on a Solvency II basis, approximately 63.1% of AIUK's ceded business was to Arch Reinsurance Ltd.). AIUK has informed me that its reinsurance recoverable with Arch Reinsurance Ltd. is fully collateralised and that, as at 31 December 2019, the value of the collateral held by AIUK in respect of this reinsurance asset exceeded the technical provisions in respect of this reinsurance arrangement calculated under a Solvency II basis. The collateral significantly reduces AIUK's credit risk exposure to the Arch Group and any contagion risk that the Arch Group is exposed to.

8.96 In addition, Arch Reinsurance Ltd. is also backed by the Arch Group which has a credit rating of A+ from A.M. Best, Standard & Poor's and Fitch, and a credit rating of A2 from Moody's. Based on the collateral held by AIUK and strength of Arch Group's credit ratings, I consider the risk of default of the reinsurance provided by Arch Reinsurance Ltd. to be remote.

8.97 AIUK also assesses its exposure to reinsurance bad debt on a regular basis. At present, the vast majority of AIUK's external reinsurers have a credit rating of A and above (approximately 99.97% of

AIUK's reinsurance recoverables on a Solvency II basis as at 31 December 2019) and AIUK has informed me that, on new reinsurance programmes, it will only utilise reinsurers who have at least an A credit rating and that any exceptions to this would require prior approval from AIUK's Reinsurance Steering Committee.

8.98 I have also estimated the likelihood of £30.7m and a £74.0m deteriorations in AIUK's reinsurance assets i.e. the likelihood that AIUK's experiences reinsurance defaults that are sufficiently large to reduce its SCR coverage ratio below 100% or to reduce its assets to below the value of its liabilities on a Solvency II basis.

8.99 Based on my estimation, there is a likelihood of less than 0.017% that AIUK will experience a reinsurance loss exceeding £30.7m. I also estimate that the likelihood of reinsurance losses exceeding £74.0m is 0.003%. I therefore consider the likelihood of losses due to reinsurance defaults of this magnitude to be remote.

8.100 Based on this and my experience, I consider a reduction in the reinsurance asset as a result of default by reinsurers of 22.2% or greater to be remote. As a result, my opinion is that I consider that AIUK will have sufficient assets to meet its liabilities in all reasonably foreseeable reinsurance default scenarios.

Deterioration in the value of AIUK's investment portfolio

8.101 AIUK has projected that it will have an investment portfolio with a value of £102.0m, as measured under a Solvency II basis, following the Scheme on the Effective Date. However, AIUK's projection was estimated prior to the COVID-19 event and therefore does not allow for the losses as a result of this event. As discussed in paragraph 8.41, AIUK assessed that there was a 3.1% deterioration in the value of its investment portfolio as a result of the COVID-19 event. Adjusting for this deterioration, the projected value of the investment portfolio following the Scheme on the Effective Date is £98.5m.

8.102 In order to reduce assets such that they fall below the liabilities, AIUK would need to experience a reduction in the value of its investments in the region of £74.0m (75.1%).

8.103 AIUK has informed me that, following the Scheme, it expects most of its investment portfolio to be in government and corporate bonds, which is also the case currently. It has informed me that these debt instruments had credit ratings between AAA and BBB at 31 December 2019 (97.8% had credit ratings of A and above) and that this strategy of investing predominantly in highly rated bonds is expected to remain the case following the Scheme.

8.104 Whilst highly rated debt instruments can and do lose value over the short term due to changes in interest rates and credit spreads, they are generally quite stable in the medium and long term.

8.105 Based on the composition of AIUK's investment portfolio, my opinion is that the likelihood that the value of the investment portfolio will fall by 75.1% is remote. Consequently, based on this and my experience, my opinion is that the likelihood that AIUK will have insufficient assets to meet its liabilities as they fall due as a result of a deterioration in the value of its investments is remote.

Financial losses from a significant catastrophe event followed by reinsurer defaults

8.106 In this stress test, I considered a combination of some of the above stress tests occurring simultaneously, in particular a severe deterioration in AIUK's net best estimate technical provisions and the impact of financial losses from significant catastrophe events.

8.107 Under this scenario I have assumed that the following events occur simultaneously or close to each other:

- AIUK experiences a severe natural catastrophe loss during 2021. Under this scenario, AIUK experiences a severe natural catastrophe event with an aggregate return period of 1 in 250 years that reduce Eligible Own Funds by £2.1m in 2021. As discussed above, AIUK has estimated that there is a 0.4% likelihood that this scenario would occur and result in a loss of £2.1m net of reinsurance.

- There is a £30.7m reduction in AIUK's reinsurance asset as a result of default of a reinsurer. As discussed above, I have assessed that this has a likelihood of less than 0.016%.

8.108 Under this scenario, AIUK's Own Funds fall by approximately £32.8m million in total, which would reduce AIUK's SCR coverage ratio to 95.1%. However, the value of its assets would still exceed its liabilities.

8.109 Based on my experience, I consider this scenario to be remote since:

- Individually, I consider each event to be remote.
- I consider the probability of the combination of the two stresses to be remote since they would need to occur simultaneously or close to each other so that AIUK was unable to recover

8.110 Given the above, it is my view that the likelihood that AIUK will have insufficient capital to pay claims to its policyholders following such a combination of events is remote.

Deterioration of AIUK's net best estimate technical provisions for the Remaining Portfolio and a significant deterioration in the value of AIUK's investment portfolio

8.111 In this stress test, I considered a combination of some of the above stress tests occurring simultaneously, in particular a severe deterioration in AIUK's net best estimate technical provisions and the impact of financial losses from a significant deterioration in the value of AIUK's investment portfolio.

8.112 Under this scenario I have assumed that the following events occur simultaneously or close to each other:

- Net technical provisions deteriorate by £30.7m. As discussed above, I have assessed that this has a likelihood of less than 0.38%.
- AIUK suffers a £29.5m, or 30.0%, loss on the value of its investment portfolio. As discussed in paragraphs 8.103 and 8.104 above, AIUK's investments comprises mostly of highly rated bonds which are held to maturity. Based on this, my opinion is that the likelihood of a 30% loss in the value of AIUK's investments is unlikely.

8.113 Under this scenario, AIUK's Own Funds fall by approximately £60.3m million in total, which would reduce AIUK's SCR coverage ratio to 31.7%. However, the value of its assets would still exceed its liabilities.

8.114 Based on my experience, I consider this scenario to be remote since:

- I consider the net technical provisions deterioration scenario above to be remote
- I consider the investment loss scenario above to be unlikely.
- I consider the probability of the combination of the two stresses to be remote since they would need to occur simultaneously or close to each other so that AIUK was unable to recover

8.115 Given the above, it is my view that the likelihood that AIUK will have insufficient capital to pay claims to its policyholders following such a combination of events is remote.

Summary of my testing

8.116 As shown in table 8.4, AIUK will maintain a buffer in relation to the SCR following the Scheme. The buffer is designed to ensure that it only breaches its regulatory capital requirements in extreme scenarios.

8.117 The testing above demonstrates the types of events that would need to happen in order for Own Funds to fall beneath the SCR. In addition, the testing indicates that the likelihood of AIUK's assets falling below its liabilities.

8.118 The testing that I have undertaken and which I have described in paragraphs 8.64 to 8.115 demonstrates to me that, should the Scheme become effective, the likelihood of the assets of AIUK falling beneath its liabilities is remote.

AIEU

AIEU's capital requirements

AIEU's approach to calculating its regulatory capital requirements

8.119 AIEU calculates its Solvency Capital Requirement (SCR) using the Standard Formula methodology, outlined in paragraphs 8.7 to 8.8.

Appropriateness of the Standard Formula for calculating AIEU's regulatory capital requirements

8.120 As I previously discussed in paragraph 8.9, firms that choose to use the Standard Formula must be able to demonstrate that it is appropriate, and that any deviations from the assumptions underlying the Standard Formula are not significant. AIEU carries out this exercise as part of its ORSA.

8.121 The regulatory guidelines on the ORSA state that a firm may, as a first step, perform a qualitative analysis and that, if that indicates that the deviation is not significant, a quantitative assessment is not required. I have reviewed AIEU's latest review of assumptions underlying the Standard Formula and AIEU's assessment that the deviation of its risk profile from the standard formula assumptions are not significant enough to require a quantitative assessment to be carried out.

8.122 I have considered AIEUs approach to validating the use of the Standard Formula and have considered the results of this review. In doing so, I agree that the Standard Formula is appropriate for calculating AIEU's regulatory capital requirements for the following reasons:

- While there are some deviations from the assumptions underlying the Standard Formula, such as within the Operational Risk module, I have reviewed details of these deviations and do not deem them to be material
- I understand that AIEU takes further steps to ensure that risks that are not included within the Standard Formula are monitored against appropriate tolerances in regular reporting to the Risk Committee of the Board.

AIEU's Solvency II Own Funds

8.123 AIEU had £50.5m of unrestricted Tier 1 Own Funds as at 31 December 2019. As per Solvency II regulations, Tier 1 Own Funds can be recognised in full to meet the SCR and the MCR capital requirements. The full value of the Tier 1 Own Funds is made up of ordinary share capital and the reconciliation reserve and is classed as unrestricted Tier 1 capital.

8.124 As at 31 December 2019, AIEU did not hold any Tier 2 or Tier 3 Own Funds.

8.125 The table below shows the breakdown of AIEU's Eligible Own Funds to meet the SCR

Table 8.7: AIEU's Eligible Own Funds at 31 December 2019

£m	
Tier 1	50.5
Tier 2	0.0
Tier 3	0.0
Total Eligible Own Funds	**50.5**

8.126 I have reviewed AIEU's allocation of Own Funds to the tiers and I have not identified any areas that are out of line with regulatory requirements. I also observe that all of Eligible Own Funds are Tier 1, which is the highest tier of Own Funds.

AIEU’s approach to calculating its economic capital requirements

8.127 AIEU has not calculated an economic capital requirement. It uses only its regulatory capital as described in paragraph 8.119.

8.128 Although AIEU does not calculate an economic capital requirement in addition its regulatory capital requirement, it projects the regulatory capital requirement and available capital for the next five calendar years to ensure that the business will remain solvent under AIEU’s five year business plan.

8.129 AIEU also considers a number of stressed scenarios in addition to its business plan to ensure that the business remains solvent under these scenarios.

Reasonableness of regulatory capital calculations

8.130 I note that, whilst I have considered the methodology and key assumptions for the SCR, I have not reviewed the calculations in detail. However, I have considered the output of the Standard Formula calculation and I have not identified any reason to believe that the calculated SCR materially understates or overstates the regulatory capital required by AIEU.

8.131 I have reviewed the CVs of the individuals at AIEU who were responsible for calculating the regulatory capital requirement. Based on these and my interactions with those individuals, I am satisfied that the individuals at AIEU who were responsible for these calculations have the necessary experience and expertise to undertake this work and for me to rely on their work for the following reasons:

- The CVs reviewed showed relevant experience in general insurance and actuarial roles, with adequate capital modelling and Solvency II standard formula experience
- The CVs of key team members reviewed showed that these individuals have worked at AIEU for a number of years.

AIEU’s capital strategy

8.132 I understand from AIEU that it aims to maintain a minimum capital coverage of its SCR of 120%, and that, if AIEU’s capital drops to below 110%, then it will take appropriate remedial actions.

8.133 These actions are included in AIEU’s capital management plan which is monitored and reviewed annually by the Board.

8.134 Sources of capital available to AIEU that can be realised if necessary include internal sources, such as a capital injection or capital loan from ACGL, and external sources, such as private equity or a merger.

8.135 Alternatively, AIEU has also outlined internal management actions that may be taken such as use of reinsurance, the sale of certain books of business and adjustments to its investment strategy. In more severe cases, actions include repricing, product redesign and the restriction or discontinuation of certain lines of business.

Impact of the Scheme on AIEU's balance sheets and coverage ratios

Impact on an Irish GAAP basis at 31 December 2019

8.137 The table below shows the simplified Irish GAAP balance sheets of AIEU at 31 December 2019, both before and after the Scheme. These balance sheets have been prepared by AIEU on the basis that the Scheme had become effective at 31 December 2019 and do not include an allowance for losses from the COVID-19 event.

Table 8.8: AIEU's Irish GAAP balance sheets at 31 December 2019, before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
Assets:			
Investments	66.0	23.5	89.4
Cash	4.5	-	4.5
Reinsurers' share of technical provisions	80.2	207.4	287.6
Deposits with ceding undertakings	1.0	-	1.0
Debtors	31.8	9.6	41.4
Other assets	0.1	1.0	1.2
Prepayments and accrued income	12.8	7.0	19.8
Total assets	**196.4**	**248.5**	**444.9**
Liabilities:			
Technical provisions	91.0	225.6	316.6
Creditors	37.7	5.0	42.7
Accruals and deferred income	17.4	8.7	26.1
Total liabilities	**146.1**	**239.2**	**385.3**
Net assets	**50.3**	**9.3**	**59.6**

8.138 The main changes in the balance sheet as a result of the Scheme, include an increase in technical provisions of £225.6m which is partly offset by an increase in reinsurers' share of technical provisions of £207.4m. The resulting increase in net reserves due to the transfer is £18.2m. Note that this is equal to the reduction in net reserves on the AIUK GAAP balance sheet.

Impact on a Solvency II basis at 31 December 2019

8.139 The table below shows the simplified Solvency II balance sheets and SCR coverage ratios of AIEU at 31 December 2019, both before and after the Scheme. These balance sheets have been prepared by AIEU on the basis that the Scheme had become effective at 31 December 2019 and do not include an allowance for losses from the COVID-19 event.

Table 8.9: AIEU's Solvency II balance sheets and SCR coverage ratios at 31 December 2019, before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
Assets:			
Investments	66.0	23.5	89.4
Cash	4.5	0.0	4.5
Reinsurers' share of technical provisions	29.6	182.5	212.1
Insurance and other receivables	6.4	5.1	11.5
Other assets	0.0	(1.0)	(1.0)
Total assets	**106.5**	**210.1**	**316.5**
Liabilities:			
Gross best estimate technical provisions	35.3	203.6	238.8
Risk margin	3.1	2.2	5.3
Other liabilities	15.8	5.0	20.7
Total liabilities	**54.1**	**210.7**	**264.8**
Own Funds:			
Net assets	52.4	(0.7)	51.7
Total Basic Own Funds to meet SCR	**52.4**	**(0.7)**	**51.7**
Ineligible Own Funds	(1.9)	0.0	(1.9)
Total Eligible Own Funds to meet SCR	**50.5**	**(0.7)**	**49.8**
SCR Coverage Ratio:			
Solvency Capital Requirement (SCR)	23.3	10.3	33.6
Eligible Own Funds	50.5	(0.7)	49.8
SCR coverage ratio	**216.2%**	**(68.0%)**	**148.1%**
MCR Coverage Ratio			
Minimum Capital Requirement (MCR)	5.8	2.9	8.8
Eligible Own Funds	50.5	(0.7)	49.8
MCR coverage ratio	**864.7%**	**(297.9%)**	**566.8%**

8.140 The main changes in the balance sheet as a result of the Scheme include an increase in gross best estimate technical provisions of £203.6m which is partly offset by an increase in reinsurers' share of technical provisions of £182.5m. The resulting increase in net reserves due to the transfer is £21.1m. Note that this is equal to the reduction in net reserves on the AIUK Solvency II balance sheet.

8.141 The Scheme would result in a 68.0% decrease in AIEU's SCR coverage ratio from 216.2% to 148.1% and a 297.9% reduction in its MCR coverage ratio from 864.7% to 566.8%. This is due to the fact that AIEU's SCR and MCR increase following the Scheme, mainly driven by an increase in its net technical provisions, however, the Scheme does not result in an increase in AIEU's Eligible Own Funds.

8.142 To ensure that the Scheme does not materially adversely impact the policyholders of the Existing Portfolio, AIEU has informed me that the Arch Group will inject an additional £8.9m (€10.5m) in Tier 1 capital to AIEU prior to the Scheme on 5 December 2020. I understand from AIEU that the intention is for the capital injection to restore AIEU's SCR coverage ratio following the Scheme to a level that is in line with its SCR coverage ratio prior to the Scheme. AIEU has informed me that the respective boards of directors for AIEU and Arch Financial Holdings Europe II Limited (the parent of AIEU which will be making the capital injection) have passed resolutions approving this capital injection. I discuss the capital injection and the impact on AIEU's SCR Coverage ratio at the Effective Date in paragraphs 8.158 and 8.162.

8.143 Insurance and other receivables in the table above includes insurance, intermediaries, reinsurance and trade receivables.

8.144 Other liabilities includes insurance, intermediaries, reinsurance and trade payables.

Projected SCR and Own Funds on the Effective Date

8.145 AIEU has projected its capital figures as at 31 December 2019 to provide an estimate of what it expects the equivalent figures to be as at the Effective Date, 31 December 2020.

8.146 AIEU has informed me its projected Own Funds and SCR as at the Effective Date take into account the impact from the COVID-19 event. In particular, AIEU has informed me that the following adjustments were taken into account in these projections:

- The expected loss ratio for AIEU's Mortgage Insurance Division were increased from 42.6% to 54.8% for the first quarter of 2020
- The premium volume in respect of new mortgage business was decreased by 50% in 2020 and decreased by 25% in 2021 relative to AIEU's original business plan
- AIEU has informed me that there was a £1.7m gain in the value of its investments between 31 December 2020 and 31 March 2020, primarily driven by changes in exchange rates, and that its projected Own Funds at the Effective Date allow for the impact of this investment gain.
- AIEU has informed me that it has not experienced any credit risk losses to date as a result of this event. I have, therefore, made no adjustments in this risk area. AIEU's credit risk is primarily being driven by reinsurance counterparty risk, I discuss AIEU's reinsurance counterparties in paragraphs 8.205 to 8.208. Based on my assessment of the strength of AIEU's reinsurance counterparties, I believe that not including an adjustment for credit risk is reasonable.
- AIEU has informed me that it has not experienced any operational risk losses as a result of this event. I have, therefore, made no adjustments in this risk area.

8.147 The table below summarises AIEU's projected Own Funds at the Effective Date, prior to and following the Scheme including the adjustments to its projections in respect of the COVID-19 loss event.

Table 8.10: AIEU's projected Own Funds at 31 December 2020, before and after the Scheme

£m	Before Scheme	After Scheme
Eligible Own Funds at Effective Date (before adjustment)	**55.3**	**64.1**
Deterioration in net reserves	-0.9	-0.9
Investment losses	0.0	0.0
Increase in bad debt	0.0	0.0
Expense increase	0.0	0.0
Loss due to business volume reduction	-0.5	-0.5
Eligible Own Funds at Effective Date (adjusted for Covid-19)	**53.9**	**62.7**

8.148 The table below summarises my projection of AIEU's SCR at the Effective Date prior to and following the Scheme both before and after my adjustments for the COVID-19 loss event.

Table 8.11: AIEU's projected SCR at 31 December 2020, before and after the Scheme

£m	Before Scheme	After Scheme
SCR at Effective Date (before adjustment)	**31.8**	**37.9**
Adjustments to SCR in respect of:		
Reserve risk	0.4	0.4
Underwriting risk	0.2	0.2
Market risk – investments	0.1	0.1
Market risk - exchange rates	-	-
Credit risk	0.9	0.9
Operational risk	0.2	0.2
SCR at Effective Date (adjusted for COVID-19)	**33.7**	**39.7**

8.149 The reserve risk and underwriting risk impacts in the table above were calculated by AIEU. I have reviewed the assumptions and methodology underlying AIEU's estimate of the impacts of COVID-19 on the reserve risk and underwriting risk components of the SCR and believe them to be reasonable for the reasons I discussed in paragraph 8.146.

8.150 AIEU has informed me that it has not calculated an adjustment to its SCR in respect of credit risk. It has further informed me that this is for the following reasons:

- AIEU's credit risk is primarily being driven by reinsurance counterparty risk. AIEU's largest reinsurance counterparty is Arch Reinsurance Ltd. under the IQS. As discussed in paragraphs 8.206 to 8.208, the risk of Arch Reinsurance Ltd. defaulting on reinsurance recoveries due to AIEU is, in my view, remote.
- In respect of AIEU's remaining reinsurance counterparty exposures, the vast majority of AIEU's external reinsurers have a credit rating of A- and above (100% of AIEU's reinsurance recoverables on a Solvency II basis as at 31 December 2019). I consider that reinsurers with such ratings are unlikely to default.

8.151 I have however increased AIEU's SCR in respect of credit risk to account for the possibility of there being rating downgrades on AIEU's reinsurance counterparties brought about by a prolonged challenging general economic environment due to COVID-19. I have calculated the increase in AIEU's credit risk SCR by repeating the Solvency II standard formula SCR calculation for AIEU but assuming that the credit ratings for approximately a quarter (by volume of recovery) of AIEU's reinsurance counterparties are downgraded by one rating category.

8.152 I have also recognised that there is a possibility of there being rating downgrades on AIEU's investments driven by a prolonged poor general economic environment. I have calculated the resulting increase in AIEU's market risk SCR by repeating the Solvency II standard formula SCR calculation for AIEU but assuming the credit ratings for approximately half (by market value) of the AIEU's fixed income investments (other than sovereign debt) are downgraded by one rating category.

8.153 I have also recognised an additional amount in respect of operational risk. This amount represents the increase in the allowance for operational risk calculated under the standard formula which corresponds to the increases I have applied in respect of credit risk and market risk shown in Table 8.11.

8.154 It can be seen in the above tables that the adjustments for COVD-19 are the same both prior to and following the Scheme. This is because, as discussed in paragraph 7.74, AIUK has informed me that there is no substantial exposure to COVID-19 within the Transferring Portfolio.

8.155 I have reviewed AIEU's analysis in respect of the impact on COVID-19 on its projected Own Funds and SCR at the Effective Date and I am satisfied that AIEU's analysis and conclusion is not unreasonable for the following reasons:

- The assessments have appropriately considered AIEU's insurance portfolio and the expected impact of COVID-19 on each of AIEU's main classes of business
- The assessments appropriately considered AIEU's investment portfolio and the expected impact of COVID-19 on the value of its investments
- The assessments have appropriately considered AIEU's credit risk counterparties and the expected impact of COVID-19 on its bad debt
- The assessments have appropriately considered AIEU's exposure to operational risk and the expected impact of COVID-19 on that exposure
- The assessments have appropriately considered the impact of changes in the external environment on AIEU's risk profile, business and operations.

8.156 I will review all of the adjustments in Table 8.10 and 8.11 above in the light of the latest available information on COVID-19 and provide an update to these figures in my Supplementary Report.

Impact on a Solvency II basis at the Effective Date

8.157 As discussed in paragraphs 8.145, AIEU has projected its balance sheet as at 31 December 2019 to provide an estimate of what it expects the equivalent figures to be as at the Effective Date, 31 December 2020.

8.158 AIEU has informed me that the Arch Group have confirmed that it will inject £8.9m (€10.5m) in Tier 1 capital into AIEU by 5 December 2020. I understand from AIEU that this additional capital will be invested in the USD bond portfolio. The impact of this capital contribution on AIEU's capital figures are as follows:

- An increase in AIEU's Own Funds of £8.9m
- An increase in AIEU's Investments of £8.9m
- An increase in SCR of £2.0m due to the increase in currency risk

8.159 AIEU has also allowed for the impact of this capital contribution in its projections as at the Effective Date.

8.160 The table below shows the simplified Solvency II balance sheets and SCR coverage ratios of AIEU at the Effective Date, 31 December 2020, both before and after the Scheme. The tables shown below include the adjustment in respect of the COVID-19 loss I discussed in paragraph 8.146 and the capital injection from the Arch Group which I discuss in paragraphs 8.158 and 8.162.

Table 8.12: AIEU's Solvency II balance sheets and SCR coverage ratios at 31 December 2020, before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
Assets:			
Investments	71.1	20.1	91.1
Cash	4.3	0.0	4.3
Reinsurers' share of technical provisions	58.3	139.4	197.7
Insurance and other receivables	12.8	4.5	17.3
Other assets	0.0	0.0	0.0
Total assets	**146.4**	**164.0**	**310.4**
Liabilities:			
Gross best estimate technical provisions	71.7	152.2	223.9
Risk margin	4.9	1.5	6.4
Other liabilities	14.0	1.5	15.5
Total liabilities	**90.6**	**155.2**	**245.8**
Own Funds:			
Net assets	55.8	8.8	64.6
Total Basic Own Funds to meet SCR	55.8	8.8	64.6
Ineligible Own Funds	(1.9)	0.0	(1.9)
Total Eligible Own Funds to meet SCR	**53.9**	**8.8**	**62.7**
SCR Coverage Ratio:			
Solvency Capital Requirement (SCR)	33.7	6.0	39.7
Eligible Own Funds	53.9	8.8	62.7
SCR coverage ratio	**160.1%**	**-2.3%**	**157.8%**

8.161 At the Effective Date, the main impact on AIEU's projected Solvency II balance sheet, as a result of the Scheme, is an increase in gross best estimate technical provisions of £152.2m which is partly offset by an increase in reinsurers' share of technical provisions of £139.4m. The resulting change in net technical provisions is £12.8m. Note that this is equal to the reduction in net reserves on the projected AIUK Solvency II balance sheet at the Effective Date.

8.162 At the Effective Date and excluding the impact from the £8.9m capital injection, discussed in paragraph 8.158, AIEU's SCR coverage ratio would decrease following the Scheme from 157.8% to 135.4%. This is a decrease in AIEU's capital position on a regulatory basis. AIEU's regulatory capital position is calculated using the Solvency II Standard Formula and, as I discuss in paragraph 8.67, this measures risk over a one year time horizon.

8.163 I note however that the decrease in AIEU's SCR Coverage Ratio or its regulatory capital position is offset by the capital injection. Allowing for the impact of the additional capital following the Scheme, AIEU's SCR Coverage Ratio only decreases by 2.3% from 160.1% to 157.8%.

8.164 The impact of the transfer on AIEU's capital figures are discussed in further detail in Section 9.

ORSA

8.165 I have been provided with a copy of AIEU's ORSA report, dated 18 December 2019, and an update to this report dated 10 July 2020 which has been approved by AIEU's Board on 10 July 2020. The ORSA includes an analysis of AIEU's forward looking assessment of its risk profile and considers the impact of the Transferring Portfolio.

Economic capital requirement

8.166 As discussed in paragraph 8.128, AIEU does not calculate an economic capital requirement.

Stress tests within the ORSA report

8.167 AIEU has considered various stress and scenario tests within its ORSA to test the robustness of its capital position. The stress and scenario testing covers a wide range of risks that AIEU is exposed to such as an economic crisis, adverse loss experience and an IT data system failure. I have reviewed the approach undertaken in relation to these stresses and consider the approach and key assumptions to be reasonable for the following reasons:

- The parameters underlying AIEU's analysis are reasonable and have been applied appropriately
- AIEU has considered 10 stress tests
- The stress tests considered have taken into account AIEU's current risk profile and the key risks that may affect it from within its portfolio or from external environments or large events
- In addition to the 10 stress tests above, AIEU also performed a number of reverse stress tests which considered the impact from severe events.

8.168 None of the stress tests undertaken would reduce AIEU's SCR coverage ratio below 120%.

8.169 AIEU's ORSA was however performed prior to the COVID-19 event and AIEU did not consider the impact of this event in its stress and scenario testing. In order to assess the potential impact of the COVID-19 event on AIEU's SCR coverage ratio, I have considered this in my own stress testing. I discuss my analysis and my estimate of the impact from the COVID-19 event on AIEU's SCR coverage ratio, under a worst realistic case scenario, in paragraphs 8.193 to 8.201.

Stress testing

8.170 In order to test the sufficiency of AIEU's Own Funds and to support my conclusions, I have undertaken a number of high-level stress tests as set out in the paragraphs below.

8.171 I have assessed the resilience of AIEU's capital position against a number of scenarios. I have selected the scenarios below based on my review of AIEU's business structure and risk profile. The scenarios that I have selected represent, in my opinion, the risks that could most significantly impact AIEU's financial and capital strength. The scenarios I have considered in my stress tests are as follows:

- A deterioration of AIEU’s net best estimate technical provisions
- A deterioration of AIEU’s expected loss ratio for unexpired and new business
- Financial losses from a significant catastrophe events
- Financial losses from significant loss event affecting AIEU’s mortgage insurance classes of business
- Further financial losses arising on the COVID-19 event
- A reduction in the reinsurance asset as a result of reinsurer defaults
- A deterioration in the value of AIEU’s investment portfolio.

8.172 In addition, I have also considered the following combinations of the above stress tests occurring simultaneously:

- Financial losses from a significant catastrophe event followed by reinsurer defaults
- A deterioration of the net best estimate technical provisions and a significant deterioration in the value of AIEU’s investment portfolio

8.173 I have also estimated likelihoods for the various levels of deterioration in AIEU’s projection of its net technical provisions using the assumptions underlying Solvency II Standard Formula and adjusting these assumptions to allow for the additional risk that would arise up to the time when all cashflows in respect of AIEU’s technical provisions have been settled. The methodology for this analysis is similar to the one I used in my stress testing analysis for AIUK which I discuss in paragraphs 8.67 and 8.68.

8.174 For the purpose of these stress tests, I have considered AIEU’s projected financial position on the Effective Date following the Scheme. As discussed in paragraph 8.146, AIEU’s projection of the capital requirement and own funds at the at the Effective Date have taken into account the COVID-19 event, I have therefore not adjusted AIEU’s estimates of the regulatory capital requirement and own funds for COVID-19.

8.175 It follows that I have performed the stress testing on the basis that AIEU’s starting financial position at the Effective Date is as follows:

- SCR = £39.7m
- Eligible Own Funds = £62.7m
- Excess of Own Funds over the SCR = £23.0m
- SCR coverage ratio = 157.8%

Deterioration of AIEU’s net best estimate technical provisions

8.176 AIEU’s projected net best estimate technical provisions following the Scheme on the Effective Date are £26.1m. I have been informed by AIEU’s that its projection of the net best estimate technical provisions is on a best estimate basis and that it allows for the impact of any material events between the time of my analysis and the Effective Date that are known to AIEU and may have a material impact AIEU’s net technical provisions. I therefore consider £26.1m to be a fair proxy for the actual net best estimate technical provisions at the Effective Date following the Scheme.

8.177 In order to reduce its SCR coverage ratio from 157.8% to 100% or below, AIEU would need to experience a deterioration in its net best estimate technical provisions in the region of £23.0m (87.8%) of its net best estimate technical provisions, from £26.1m to £49.1m. I have estimated that there is a likelihood of less than 1.84% that the net best estimate provisions will deteriorate by £23.0m. I therefore consider a deterioration of this magnitude to be unlikely.

8.178 Furthermore, in order for AIEU’s assets to fall beneath its liabilities, it would need to experience a deterioration in the region of £62.7m (239.7%) in its net best estimate technical provisions from £26.1m to £88.8m. I have estimated that there is a likelihood of less than 0.011% that the net best estimate provisions will deteriorate by £88.8m. I therefore consider a deterioration of this magnitude to be remote.

8.179 In reaching this conclusion, I have considered the following:

- As discussed in paragraph 7.55, I consider AIEU's estimate of its Solvency II best estimate technical provisions to be within a reasonable range of estimates
- My approach to the estimation of the likelihood is based on an extrapolation of the assumptions underlying the Solvency II Standard Formula calculation. Based on an assessment of the appropriateness of the assumptions underlying the Solvency II Standard Formula for AIEU's business and risk profile, which is described in paragraphs 8.120 to 8.122, I am satisfied that I am able to place reliance on the assumptions underlying the Solvency II Standard Formula for this estimation.
- AIEU has a well-diversified portfolio of insurance liabilities and therefore an 87.8% deterioration would need to correspond to a far more severe deterioration in a small number of classes, either simultaneously or gradually over time.

Deterioration in expected loss ratio for unexpired and new business

8.180 AIEU's expected profit before tax for the 2021 financial year is projected to be £1.1m.

8.181 In order to reduce its SCR coverage ratio to 100% or below, AIEU would need to experience a deterioration in the region of £24.1m of its profit before tax, from a profit of £1.1m to a loss of £23.0m. The corresponding deterioration required in respect of AIEU's net loss ratio is 156.5% from 70.6% to 227.1% and the corresponding change in the net combined ratio is from 110.7% to 267.2%.

8.182 Furthermore, in order for AIEU's assets to fall beneath its liabilities, it would need to experience a deterioration in the region of £63.8m in its profit before tax, from a profit of £1.1m to a loss of £62.7m. The corresponding deterioration required in respect of AIEU's net loss ratio is 414.5% from 70.6% to 485.1% and the corresponding change in the net combined ratio is from 110.7% to 525.2%.

8.183 Using the assumptions underlying the Solvency II Standard Formula and AIEU's expectation of its business mix and volume in 2021, I have estimated that there is a 0.5% likelihood that AIEU's losses will exceed £17.6m over a one-year time horizon. The likelihood that losses will exceed £24.1m is therefore significantly lower than 0.5%, and the likelihood that losses will exceed £63.8m is lower still. I therefore consider the likelihood of a deterioration of £63.8m to be remote.

8.184 In reaching this conclusion, I have considered the following:

- As discussed in paragraphs 8.145 to 8.146, AIEU's projection of its Own Funds and SCR at the Effective Date, before applying this stress test, include an allowance for the COVID-19 loss on a best estimate basis and that, in my opinion, AIEU's allowance for COVID-19 is not unreasonable.
- Based on an assessment of the appropriateness of the assumptions underlying the Solvency II Standard Formula for AIEU's business and risk profile, described in paragraphs 8.120 to 8.122, I am satisfied that I am able to place reliance on the assumptions underlying the Solvency II standard formula for this estimation.
- AIEU has a well-diversified portfolio of insurance liabilities and therefore a 156.5% deterioration in its net loss ratio would need to correspond to a far more severe deterioration in a small number of classes, either simultaneously or gradually over time.

Financial losses from a significant catastrophe event

8.185 This stress test assumes that AIEU experiences a loss from a significant natural catastrophe event during 2021. The severity of this natural catastrophe event was assessed by AIEU to be equivalent to a

1-in-250 year event and results in a loss of £70.3m gross of all reinsurance or £17.0m net of external reinsurance for AIEU.

8.186 AIEU has estimated that the corresponding net loss that it would experience following this event will be £2.6m including recoveries from the IQS. The resulting deterioration in AIEU's Eligible Own Funds from this event is therefore £2.6m.

8.187 Given that this scenario test has been constructed based on a 1-in-250 year event, there is a 0.4% likelihood that this scenario would occur. I therefore consider such an occurrence to be remote. I note that, even in this scenario, AIEU is expected to maintain a SCR coverage ratio substantially in excess of 100% and that it would require a loss 8.8 times higher than this (i.e. a loss of £23.0) to reduce AIEU's SCR coverage ratio to 100%.

8.188 In addition, it would require a net loss 24.0 times higher (i.e. a loss of £62.7m) for its assets to fall below its liabilities. I consider the likelihood of a loss of £62.7m arising from a significant catastrophe event to be remote.

Financial losses from a significant loss event affecting AIEU's mortgage insurance classes of business

8.189 This stress test assumes that AIEU experiences a severe economic loss event during 2021 which result in significant increase in insurance claims in its mortgage insurance classes of business. The severity of this event is assessed by AIEU to be equivalent to a 1-in-250 year event and results in a gross loss of £18.6m for AIEU.

8.190 AIEU has estimated that the corresponding net loss that it would experience following this event will be £1.9m including recoveries from the IQS. The resulting deterioration in AIEU's Eligible Own Funds from this event is therefore £1.9m.

8.191 Given that this scenario test has been constructed based on a 1-in-250 year event, there is a 0.4% likelihood that this scenario would occur. I therefore consider such an occurrence to be remote. I note that, even in this scenario, AIEU is expected to maintain a SCR coverage ratio substantially in excess of 100% and that it would require a net loss 12.2 times higher than this (i.e. a loss of £23.0m) to reduce AIEU's SCR coverage ratio to 100%.

8.192 In addition, it would require a net loss 33.4 times higher (i.e. a loss of £62.7m) for AIEU's assets to fall below its liabilities. I consider the likelihood of a loss of £62.7m arising from a catastrophe event to be remote.

Further financial losses arising on the COVID-19 event

8.193 I have calculated a very pessimistic but plausible loss that could follow a new pandemic event or a worsening or second wave of the current COVID-19 pandemic event. I consider the impact of this below.

8.194 I have estimated the property, liability and mortgage insurance losses under this scenario, I used the assumptions underlying the Solvency II Standard Formula calculation, applying the same methodology that I discuss in paragraphs 8.67 and 8.68. Since the Solvency II SCR is on a one-year basis (i.e., it considers the risk over a time period of one year), I included an adjustment in my calculations for the additional risk that would arise up to the time when all cashflows have been settled.

8.195 I have assumed the following losses are assumed under this scenario:

- There is a significant increase in the claims on AIEU's property classes of business. The severity of this event is assessed to be equivalent to a 1-in-200 year event and results in a loss of £11.7m net of reinsurance.

- There is a significant increase in the claims on AIEU's liability classes of business. The severity of this event is assessed to be equivalent to a 1-in-200 year event and results in a loss of £16.7m net of reinsurance.
- There is a significant increase in the claims on AIEU's mortgage insurance classes of business. The severity of this event is assessed to be equivalent to a 1-in-200 year event and results in a loss of £4.2m net of reinsurance.
- There is a 10% reduction in AIEU's total written premium volume in the following trading year in addition to the 25% reduction in AIEU in respect of mortgage business as discussed in paragraph 8.146. This reduces AIEU's ability to offset its operational costs and leads to a £0.5m net underwriting loss.
- There is a 300 basis point increase in interest rates which results in a £8.5m deterioration in the market value of AIEU's investment portfolio.
- There is a 25.0% deterioration in the Euro to US Dollar exchange rate. Since the majority of AIEU's capital is held in US Dollars, this reduces the Euro value of its Own Funds by £13.5m.

8.196 In my view, the above represents a very pessimistic but plausible outcome for AIEU.

8.197 Under this scenario, AIEU's Own Funds fall by approximately £55.1m million in total, which would reduce AIEU's SCR coverage ratio to 19.1%. However, the value of its assets would still exceed its liabilities.

8.198 Based on my experience of the insurance market, I have observed that mortgage insurance claims have historically demonstrated a high degree of correlation to the general economic cycle. Given that the COVID-19 event has resulted in a significant deterioration in the general economic environment, it is, in my opinion, possible that the factors underlying the Solvency II Standard Formula may understate the 1-in-200 year loss for mortgage insurance business in the current environment.

8.199 I have therefore sensitivity tested the severity assumption in respect of AIEU's mortgage insurance class of business. In particular, I have considered the impact from the following on the total loss under this scenario:

- The net loss on AIEU's mortgage insurance class of business is in line with a 1-in-500 year mortgage indemnity loss under the Standard Formula. This results in a £5.2m loss to AIEU net of reinsurance.
- The loss on AIEU's mortgage insurance class of business is £8.4m net of reinsurance (i.e. double my estimate of the 1-in-200 year loss above).

8.200 Under both of these alternatives, the value of AIEU's assets would still exceed its liabilities.

8.201 As the scenario above represents a very pessimistic but plausible outcome for AIEU and that AIEU's assets remain higher than its liabilities under this scenario, my opinion is that I consider that AIEU will have sufficient assets to meet its liabilities following a reasonably foreseeable worsening of the COVID-19 global pandemic or following a new reasonably foreseeable global pandemic.

Reduction in the reinsurance asset as a result of default by reinsurers

8.202 AIEU's projected net best estimate of the reinsurers' share of technical provisions at the Effective Date amount to £197.7m. In order to reduce its SCR coverage ratio to 100% or below, AIEU would need to experience a reduction in the value of its reinsurance asset in the region of £23.0m, or 11.6%, as a result of default by reinsurers. In addition, AIEU would need to experience a reduction in the value of its reinsurance recoveries in the region of £62.7m, or 31.7%, for its assets to fall below its liabilities.

8.203 AIEU benefits from substantial reinsurance from the Arch Group (at 31 December 2019, on a Solvency II basis, approximately 87.5% of AIEU's ceded business was to Arch Reinsurance Ltd. and 87.6% in total to entities within the Arch Group). AIEU is therefore exposed to significant group risk through its exposure with Arch Reinsurance Ltd..

8.204 I also note that AIEU's reinsurance asset from Arch Reinsurance Ltd. will increase significantly following the Scheme. As I mentioned in paragraphs 5.15 to 5.18, AIUK benefits from the IQS which is an 85% quota share protection from Arch Reinsurance Ltd. The Transferring Portfolio also benefits from this quota share and the IQS recoveries in respect of the Transferring Portfolio will transfer to AIEU following the Scheme.

8.205 I discussed in paragraph 9.22that AIUK's reinsurance recoverable with Arch Reinsurance Ltd. is fully collateralised. However, I understand that no collateral is transferring to AIEU under the Scheme. I have therefore assessed the financial strength of Arch Reinsurance Ltd. in order to assess the likelihood of it defaulting. In particular, I have considered Arch Reinsurance Ltd.'s regulatory capital position as at 31 December 2019.

8.206 Arch Reinsurance Ltd. is domiciled in Bermuda and is regulated by the Bermuda Monetary Authority. Its capital position is subject to the Bermudian regulatory regime which has been granted Solvency II equivalence by the European Commission. I have compared the capital requirements for insurers under the Bermudian regime to those under Solvency II and believe them to be comparable.

8.207 As at 31 December 2019, Arch Reinsurance Ltd. had $15.0bn in Eligible Capital, the Bermudian equivalent of the Solvency II Eligible Own Funds. In comparison, its Enhanced Capital Requirement, the Bermudian equivalent of the Solvency II SCR, was $4.3bn. Arch Reinsurance Ltd.'s excess capital on a regulatory basis was therefore $10.7bn and its capital coverage ratio was 348.8%. The strength of Arch Reinsurance Ltd.'s capital coverage ratio reduces AIEU's credit risk exposure to the Arch Group and any contagion risk that the Arch Group is exposed to.

8.208 In addition, Arch Reinsurance Ltd. is backed by the Arch Group which has a credit rating of A+ from A.M. Best, Standard & Poor's and Fitch, and a credit rating of A2 from Moody's.

8.209 Based on the strength of Arch Reinsurance Ltd.'s capital coverage ratio and the quantum of excess capital available, as well as the strength of Arch Group's credit ratings, I consider the risk of default on the IQS to be remote.

8.210 AIEU also assesses its exposure to reinsurance bad debt on a regular basis. At present, the vast majority of AIEU's external reinsurers have a credit rating of A- and above (100.0% of the 2019 reinsurance recoveries as at 31 December 2019 on a Solvency II basis) and AIEU has informed me that, on new reinsurance programmes, it will only utilise reinsurers who have at least an A- credit rating or where the protection is fully collateralised.

8.211 I have also estimated the likelihood of £23.0m and a £62.7m deteriorations in AIEU's reinsurance assets i.e. the likelihood that AIEU's experiences reinsurance defaults that are sufficiently large to reduce its SCR coverage ratio below 100% or to reduce its assets to below the value of its liabilities on a Solvency II basis.

8.212 Based on my estimation, there is a likelihood of less than 0.04% that AIEU will experience a reinsurance loss exceeding £23.0m. I also estimated that the likelihood of reinsurance losses exceeding £62.7m is 0.005%. I therefore consider the likelihood of losses due to reinsurance defaults of this magnitude to be remote.

8.213 Based on this, I consider a reduction in AIEU's reinsurance asset as a result of default by reinsurers of 11.6% or greater to be remote. As a result, my opinion is that I consider that AIEU will have sufficient assets to meet its liabilities in all reasonably foreseeable reinsurance default scenarios.

Deterioration in the value of AIEU's investment portfolio

8.214 AIEU has projected that it will have an investment portfolio with a value of £91.1m, as measured under a Solvency II basis, following the Scheme on the Effective Date.

8.215 In order to reduce assets such that they fall below the liabilities, AIEU would need to experience a reduction in the value of its investments in the region of £62.7m (68.8%).

8.216 AIEU has informed me that, following the Scheme, it expects most of its investment portfolio to be in government and corporate bonds, which is also the case currently. It has informed me that these debt instruments had credit ratings between AAA and BBB at 31 December 2019 (100% had credit ratings of A- and above) and that this strategy of investing predominantly in highly rated bonds is expected to remain the case following the Scheme.

8.217 As I discussed in paragraph 8.104, whilst highly rated debt instruments can and do lose value over the short term due to changes in interest rates and credit spreads, they are generally quite stable in the medium and long term.

8.218 Based on the composition of AIEU's investment portfolio, my opinion is that the likelihood that the value of the investment portfolio will fall by 68.8% is remote. Consequently, based on this and based on my experience, my opinion is that I consider that AIEU will have sufficient assets to meet its liabilities in all reasonably foreseeable deteriorations in the value of its investment portfolio.

Financial losses from a significant catastrophe event followed by reinsurer defaults

8.219 In this stress test, I considered a combination of some of the above stress tests occurring simultaneously, in particular a severe deterioration in AIEU's net best estimate technical provisions and the impact of financial losses from significant catastrophe events.

8.220 Under this scenario I have assumed that the following events occur simultaneously or close to each other:

- AIEU experiences a severe natural catastrophe loss during 2021. Under this scenario, AIEU experiences a severe natural catastrophe event with an aggregate return period of 1 in 250 years that reduce Eligible Own Funds by £2.6m in 2021. As discussed above, AIEU has estimated that there is a 0.4% likelihood that this scenario would occur and result in a loss of £2.6m net of reinsurance.
- There is a £23.0m reduction in AIEU's reinsurance asset as a result of reinsurer defaults. As discussed above, I have assessed that this has a likelihood of less than 0.04%.

8.221 Under this scenario, AIEU's Own Funds fall by approximately £25.6m million in total, which would reduce AIEUs SCR coverage ratio to 93.4%. However, the value of its assets would still exceed its liabilities.

8.222 Based on my experience, I consider this scenario to be remote since:

- Individually, I consider each event to be remote.
- I consider the probability of the combination of the two stresses to be remote since they would need to occur simultaneously or close to each other so that AIEU was unable to recover

8.223 Given the above, it is my view that the likelihood that AIEU will have insufficient capital to pay claims to its policyholders following such a combination of events is remote.

Deterioration of AIEU’s net best estimate technical provisions for the Remaining AIEU Portfolio and a significant deterioration in the value of AIEU’s investment portfolio

8.224 In this stress test, I considered a combination of some of the above stress tests occurring simultaneously, in particular a severe deterioration in AIEU’s net best estimate technical provisions and the impact of financial losses from a significant deterioration in the value of AIEU’s investment portfolio

8.225 Under this scenario I have assumed that the following events occur simultaneously or close to each other:

- Net technical provisions deteriorate by £35.0m. I have assessed that this has a likelihood of less than 0.35%. Based on this, my opinion is that the likelihood of a deterioration of this magnitude is remote.
- AIEU suffers a £22.8m, or 25.0%, loss on the value of its investment portfolio. As discussed in paragraphs 8.216 and 8.217 above, AIEU’s investments comprises mostly of highly rated bonds which are held to maturity. Based on this, my opinion is that the likelihood of a 25% loss in the value of AIEU’s investments is unlikely.

8.226 Under this scenario, AIEU’s Own Funds fall by approximately £57.8m million in total, which would reduce AIEU’s SCR coverage ratio to 12.3%. However, the value of its assets would still exceed its liabilities.

8.227 Based on my experience, I consider this scenario to be remote since:

- I consider the net technical provisions deterioration scenario above to be remote
- I consider the investment loss scenario above to be unlikely.
- I consider the probability of the combination of the two stresses to be remote since they would need to occur simultaneously or close to each other so that AIEU was unable to recover

8.228 Given the above, it is my view that the likelihood that AIEU will have insufficient capital to pay claims to its policyholders following such a combination of events is remote.

Summary of my testing

8.229 As shown in table 8.8, AIEU will maintain a buffer in relation to the SCR following the Scheme. The buffer is designed to ensure that it only breaches its regulatory capital requirements in extreme scenarios.

8.230 The testing above demonstrates the types of events that would need to happen in order for Own Funds to fall beneath the SCR. In addition, the testing indicates that the likelihood of AIEU’s assets falling below its liabilities is remote.

8.231 The testing that I have undertaken and which I have described in paragraphs 8.170 to 8.228 demonstrates to me that, should the Scheme become effective, the likelihood of the assets of AIEU falling beneath its liabilities is remote.

8.232 The testing above assumes that the Arch Group injects £8.9m in Tier 1 capital into AIEU prior to the Effective Date. On this basis, in order to reduce AIEU’s assets below its liabilities, AIEU will need to experience a loss of £62.7m. In the absence of the capital injection, AIEU’s Own Funds will be £8.9m less and, in order to reduce AIEU’s assets below its liabilities, AIEU will need to experience a loss of £53.8m. I have considered the impact that this lower level of Own Funds will have on my conclusions from my stress testing in paragraphs 8.170 to 8.228. Although the likelihood of AIEU experiencing a £53.8m loss is self-evidently not as remote as a £62.7m loss, I believe that this level of loss is still unlikely.

9 Policyholder security

9.1 In this section, I describe the effect of the Scheme on each group of policyholders with regards to security, including under insolvency, and explain how I have reached my conclusions.

9.2 The amounts shown for the positions after the Scheme are hypothetical, based on the Scheme becoming effective on the Effective Date.

Impact of the Scheme on the security of policyholders

9.3 The capital requirements and the approach to capital modelling of AIUK and AIEU are discussed in Section 8. The information in Tables 9.1 and Table 9.2 below are a summary of the information in Section 8 which is shown here for convenience.

Impact of the Scheme on AIUK's SCR solvency position at the Effective Date

9.4 The table below shows the change in AIUK's projected SCR coverage ratio at the Effective Date as a result of the Scheme. These figures are consistent with the balance sheets shown earlier in this report in Section 8, and, as discussed in paragraph 8.57, consider the impact of COVID-19.

Table 9.1: AIUK's SCR and ECR coverage ratios at the Effective Date, before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
SCR	49.0	-5.8	43.2
Eligible Own Funds to meet the SCR	74.0	0.0	74.0
Excess of Own Funds over the SCR	24.9	5.8	30.7
SCR coverage ratio	150.8%	20.3%	171.1%
ECR	42.8	-5.8	37.0
Eligible Own Funds to meet the ECR	55.7	0.0	55.7
Excess of Own Funds over the ECR	12.9	5.8	18.7
ECR coverage ratio	130.0%	20.4%	150.4%

9.5 AIUK's solvency position improves following the Scheme. In particular, the value of AIUK's Eligible Own Funds remain the same following the Scheme however there is a £5.8m decrease in AIUK's SCR following the Scheme due to a decrease in AIUK's insurance liabilities under the Scheme. The resulting impact is an increase in AIUK's SCR coverage ratio from 150.8% to 171.1% following the Scheme.

9.6 The Scheme has a similar impact on AIUK's solvency position on an economic basis, which also improves following the Scheme. The value of AIUK's Eligible Own Funds to meet the ECR remains the same following the Scheme but there is a £5.8m decrease in AIUK's ECR due to a decrease in AIUK's insurance liabilities under the Scheme. The resulting impact is an increase in AIUK's ECR coverage ratio from 130.0% to 150.4% following the Scheme.

9.7 In addition, the stress testing I have undertaken, which is described in Section 8, shows that, following the Scheme, the likelihood of AIUK's assets falling below its liabilities over the course of the run-off of the liabilities is remote.

9.8 It follows that, in my opinion, as AIUK's coverage ratio is expected to increase as a result of the Scheme, the Scheme will not have a detrimental impact on AIUK's ability to meet policyholder obligations.

Impact of the Scheme on AIEU's SCR solvency position at the Effective Date

9.9 The table below shows the change in AIEU's projected SCR coverage ratio at the Effective Date as a result of the Scheme. These are consistent with the balance sheets shown earlier in this report in Section 8. As discussed in paragraph 8.158, the figures are presented on the basis that a capital injection into AIEU of £8.9m is made by its immediate parent Arch Financial Holdings Europe II Limited, by 5 December 2020.

Table 9.2: AIEU's SCR coverage ratios at the Effective Date, before and after the Scheme

£m	Before Scheme	Impact of Scheme	After Scheme
SCR	33.7	6.0	39.7
Eligible Own Funds to meet the SCR	53.9	8.8	62.7
Excess of Own Funds over the SCR	20.2	2.7	23.0
SCR coverage ratio	160.1%	-2.3%	157.8%

9.10 The Scheme does not materially change AIEU's coverage ratio although there is a small decrease in from 160.1% before the Scheme to 157.8% following the Scheme. I also note that the Scheme results in a modest increase in the absolute value of Own Funds in excess of the SCR. These movements are driven by a £6.0m increase in AIEU's SCR due to an increase in its assets and liabilities, offset by a £8.8m increase its Eligible Own Funds. I note that the £8.8.m increase in Eligible Own Funds does not include the additional £1.9m Own Funds which I discuss in paragraph 9.13 below.

9.11 In addition, the stress testing I have undertaken, which is described in Section 8, shows that, following the Scheme, the likelihood of AIEU's assets falling below its liabilities over the course of the run-off of the liabilities is remote.

9.12 It follows that, in my opinion, the Scheme will not materially reduce the likelihood of AIEU being able to meet policyholder obligations.

9.13 AIEU has also informed me that it intends to make an application to the CBI to allow it to recognise £1.9m of funds, which it has currently classified as Ineligible Own Funds, as Tier 1 Eligible Own Funds. I understand from AIEU that it intends to make this application at the same time as its application to recognise the £8.9m capital injection from Arch Financial Holdings Europe II Limited.

9.14 My conclusion in paragraph 9.12 above is based on the scenario assuming that AIEU's application to recognise the additional £1.9m in Own Funds is not approved by the CBI before the Effective Date of the Scheme.

9.15 In the table below, I compare the impact of the Scheme on AIEU's capital position under three scenarios regarding the approval of AIEU's application to recognise the additional £1.9m of Tier 1 Own Funds.

Table 9.3: Impact of CBI approval on AIEU's SCR coverage ratios at the Effective Date, before and after the Scheme

	Scenario 1 – Application is not approved by the Effective Date			Scenario 2 – Application is approved on the Effective Date			Scenario 3 – Application is approved prior to the Effective Date		
£m	**Before Scheme**	**After Scheme**	**Impact**	**Before Scheme**	**After Scheme**	**Impact**	**Before Scheme**	**After Scheme**	**Impact**
SCR	33.7	39.7	6.0	33.7	39.7	6.0	33.7	39.7	6.0
Eligible Own Funds to meet the SCR	53.9	62.7	8.8	53.9	64.6	10.7	55.8	64.6	8.8
Excess of Own Funds over the SCR	20.2	23.0	2.7	20.2	24.9	4.6	22.1	24.9	2.7
SCR coverage ratio before Scheme	160.1%	157.8%	-2.3%	160.1%	162.6%	2.5%	165.7%	162.6%	-4.2%

9.16 Scenario 1 above is same scenario that I considered in Table 9.2. As discussed in paragraph 9.12 under Scenario 1, my opinion is that the Scheme does not materially reduce the likelihood of AIEU being able to meet policyholder obligations.

9.17 Under Scenario 2, the SCR coverage ratio before the Scheme is the same as under Scenario 1. Following the Scheme, the SCR coverage ratio improves to 160.1% from 162.6%. As there is an improvement in AIEU's capital following the Scheme, under this scenario, my opinion is that the Scheme will not have a detrimental impact on AIEU's ability to meet policyholder obligations.

9.18 Under Scenario 3, there is a small decrease in AIEU's SCR coverage ratio from 165.7% before the Scheme to 162.6% following the Scheme. The reduction in the SCR coverage ratio under Scenario 3 is of a similar magnitude to that under Scenario 1. However, I note that the SCR coverage ratio following the Scheme under Scenario 3 is higher than that under Scenario 1 and the same as that under Scenario 2. Furthermore, I note that, under this scenario, the Scheme also results in a modest increase in the monetary absolute value of Own Funds in excess of the SCR Considering the foregoing, in my opinion, under Scenario 3, the likelihood of AIEU being able to meet policyholder obligations is not materially reduced as a result of the Scheme.

9.19 It follows that, in my opinion, the Scheme does not materially reduce AIEU's SCR coverage ratio following the Scheme under any of the three of the scenarios which I consider above. Based on this, I have concluded that the Scheme will not have a detrimental impact on AIEU's ability to meet policyholder obligations under any of these scenarios.

9.20 It follows from paragraph 9.12 and paragraph 9.19 that I do not believe that the Scheme will materially reduce the likelihood of AIEU being able to meet policyholder obligations.

9.21 Please note that this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

The IQS

9.22 AIUK's reinsurance recoveries from the IQS that I discussed in paragraph 5.15 are protected through a trust fund arrangement. I am satisfied that the underlying assets of the trust fund are sufficient to recover AIUK's liabilities under the IQS. In reaching this conclusion, I have considered the following:

- As at 31 December 2019 the reinsurance recoverables of the IQS were 100% collateralised.

- I understand from AIUK that the legal arrangements of the trust fund and collateral agreements have been reviewed by legal experts and that those legal experts were satisfied with the appropriateness of the arrangements in place.
- I also understand from AIUK that the collateral and trust fund have been reviewed by the PRA and that the PRA gave regulatory approval to the collateral arrangement.
- The Scheme does not reduce the reinsurance recoverables due to AIUK under the IQS.
- The appropriateness of the IQS continues to be monitored on a regular basis within the Arch group.

Remaining Portfolio

9.23 I understand from AIUK that the policyholders of the Remaining Portfolio will continue to benefit from the protection of the IQS following the Scheme and that AIUK's recoveries under the IQS will continue to be fully collateralised under the trust fund I discuss in paragraph 9.22.

9.24 Based on this and my conclusion in paragraph 9.22, in my opinion, the Scheme will not have a detrimental impact on the security provided by the IQS to the policyholders of the Remaining Portfolio.

Transferring Portfolio

9.25 As I discussed in paragraphs 8.204 and 8.205, the policyholders of the Transferring Portfolio will continue to be protected by Arch Reinsurance Ltd. under the IQS following the Scheme. However, I understand from AIEU that the reinsurance recoveries in respect of the transferring policyholders will no longer be protected by the collateral held under trust fund I discussed in paragraph 9.22 following the Scheme. It follows that, following the Scheme, the transferring policyholders will lose access to this collateral.

9.26 In paragraphs 8.205 to 8.207, I assessed the financial strength of Arch Reinsurance Ltd. and the likelihood of AIEU suffering a default on the IQS. Based on the strength of Arch Reinsurance Ltd.'s capital coverage ratio and the quantum of excess capital available, as well as the strength of Arch Group's credit ratings, I concluded that the risk of default on the IQS was remote

9.27 Based on paragraphs 9.25 and 9.26, in my opinion, the Scheme will not have a material detrimental impact on the security provided under the IQS to the policyholders of the Transferring Portfolio, despite the loss of the protection from the collateral held under the trust fund I discussed in paragraph 9.22.

Existing Portfolio

9.28 The Scheme will not result in any change to the reinsurance protection provided by Arch Reinsurance Ltd. or other entities within the Arch Group to the policyholders of the Existing Portfolio. Based on this, in my opinion, the Scheme will not have a detrimental impact on the security provided under the IQS to the policyholders of the Existing Portfolio.

Impact of the Scheme on the security of the transferring policyholders

9.29 The transferring policyholders would lose the security of AIUK as a result of the Scheme but would gain the security of AIEU. AIEU has a higher SCR coverage ratio, following the Scheme, than AIUK has before the Scheme, although it has lower Own Funds in absolute terms.

9.30 Following the Scheme, AIEU expects that all of its Own Funds will be comprised of Tier 1 Own Funds. AIEU's Tier 1 Own Funds are projected to be £62.7m following the Scheme and excluding the additional £1.9m in Tier 1 Own Funds which AIEU intends to apply to the CBI to recognise. In comparison, AIUK is projected to have Tier 1 Own Funds of £66.4m (89.2%) and Tier 2 Own Funds of £8.0m (10.3%)

following the Scheme. It follows that a greater proportion of AIEU's Own Funds will consist of Tier 1 Own Funds, which are of a higher quality than Tier 2 Own Funds, in comparison to AIUK.

Insolvency

9.31 As discussed in paragraph 6.29, under UK insolvency regulations, direct insurance claims take precedence over other claims on the insurance undertaking, with the exception of certain preferential claims (e.g. claims by employees, rights in rem etc).

9.32 As discussed in paragraph 6.43, in Ireland, the winding up of an insurance undertaking is governed by the European Union (Insurance and Reinsurance) Regulations 2015. Under these regulations, insurance claims take precedence over all other claims on the insurance undertaking with respect to the assets representing the technical provisions.

9.33 Following the Scheme, policyholders within the Transferring Portfolio will move from the UK insolvency regulations to Irish insolvency regulations. The implications under insolvency for the transferring policyholders differ depending on the assets available and their size relative to the technical provisions. In particular:

- In the event that an insurer is wound up and there are sufficient assets to cover the technical provisions, the Irish regulations and UK regulations are expected to be equally favourable to policyholders as the funds available are sufficient to cover all claims against the insurer so the relative ranking of different creditors will not impact the recovery of insurance claims
- In the event that an insurer is wound up and there are insufficient assets to cover the technical provisions, the UK regulations may be less favourable as the Irish regulations, as there may be other preferential claims that take precedence over insurance claims in the UK whereas, in Ireland, the insurance claims will take precedence over all other claims.

9.34 Following from the above, I believe that the Scheme will improve the level of security provided to the policyholders within the Transferring Portfolio in some circumstances. This is due to the fact that, in contrast to UK regulations, Irish regulations do not allow any claims, preferential or otherwise, to take precedence over direct insurance claims.

Compensation Schemes

9.35 As discussed in paragraphs 6.30 to 6.32, consumer protection is provided to some of the transferring policyholders by the FSCS in the UK prior to the Scheme.

9.36 Most private policyholders, small businesses and charities are eligible for protection from the FSCS, in the event that an insurer is unable to meet its liabilities. I understand from AIUK that the majority of policyholders in the Transferring Portfolio are not eligible to claim compensation from the FSCS.

9.37 The FSCS will pay 100% of any claim incurred for compulsory insurance (e.g. motor third party liability insurance) and 90% of the claim incurred for non-compulsory insurance without any limit on the amount payable. The FSCS does not protect certain risks such as aircraft, ships, goods in transit, aircraft liability, liability of ships or credit insurance; nor does it protect contracts of reinsurance.

9.38 As well as providing cover for risks situated in the UK written by UK authorised insurance companies, the FSCS also provides cover for risks situated in EEA countries which are written by an insurer authorised in the UK through an establishment in the UK.

9.39 Transferring policyholders who are currently eligible for FSCS protection will retain their access to the FSCS following the Scheme provided that the policy was issued in the UK prior to the time UK officially left the EU, 11:00pm on 31 January 2020. However, transferring policies which are currently eligible for FSCS protection but which were written after this time will lose their access to FSCS following the Scheme. However, AIUK has informed me that it has not identified any policyholders in the Transferring

Portfolio which are currently eligible for FSCS protection but which will lose access to FSCS protection following the Scheme. The reasons for this are summarised below:

- Due to the nature of the lines of business written and the typical size of the policyholders in the Transferring Portfolio, AIUK believes that it is unlikely that any of these policyholders are eligible for FSCS protection.
- As I discussed in paragraph 5.9, AIUK has not written non-UK EEA policies since 1 January 2020 other than a small book of 40 policyholders. AIUK has also informed me that the 40 non-UK EEA policyholders written after 1 January 2020 are not eligible for FSCS compensation.

9.40 In the unlikely scenario that there are any policyholders within the Transferring Portfolio which are currently eligible for FSCS protection and which will lose FSCS protection as a result of the Scheme, these policyholders may have access to certain local schemes in their home jurisdictions, for example Irish policyholders will have access to the Insurance Compensation Fund ("ICF") which is the Irish equivalent scheme, however these may be more limited in scope.

9.41 The ICF is a fund of last resort in Ireland. As discussed in paragraph 6.44, the ICF provides cover for policyholders in relation to risks situated in Ireland where an Irish authorised non-life insurer or a non-life insurer authorised in another European Member State goes into liquidation. The protection of the ICF does not cover all policyholders' liabilities, with exclusions including health, dental and life policies.

9.42 As discussed in paragraph 6.46, the ICF limits the amount compensation available to policyholder to the lesser of 65% of the sum due to the policyholder and €825,000. In comparison, as discussed in paragraph 6.31, the FSCS will pay 100% of any claim incurred for compulsory insurance and 90% of the claim incurred for non-compulsory insurance, without any limit on the amount payable. Therefore, it is my understanding that the compensation protection that is available to transferring policyholders that are currently eligible for FSCS protection may reduce as a result of the Scheme.

9.43 It follows that, in the unlikely scenario that there are a small number of transferring policyholders who may lose FSCS protection as a result of the Scheme, in the event of AIEU experiencing significant financial difficulties, such policyholders may be disadvantaged following the Scheme with respect to access to compensation. However, even in the unlikely scenario that there are a small number of transferring policyholders who may lose FSCS protection as a result of the Scheme, I would not expect this to affect my conclusions for the following reasons:

- As discussed in sections 8 and 9 of this report, it is my opinion that AIEU will be sufficiently capitalised following the Scheme. It is therefore unlikely that AIEU will experience financial difficulties that result in the transferring policyholders requiring FSCS or ICF compensation. Given the remoteness of this scenario, I believe the actual detriment to policyholders from losing access to the FSCS to be minimal.
- If the Brexit transition period ends with no deal in place on passporting and the Scheme does not come into effect, I believe that the risk of AIEU losing the right to continue to provide insurance cover to the transferring policyholders will have a more material adverse impact on those policyholders than the changes in access to compensation as a result of the Scheme.
- In the situation where a deal on passporting is agreed with the EU after the commencement of policyholder notifications, some of the transferring policyholders may end up in a detrimental position as a result of the Scheme. However, as discussed in the first bullet point above, AIEU will be sufficiently capitalised following the Scheme and it is therefore unlikely that AIEU will experience financial difficulties. Given this, the likelihood that the policyholders will require access to a compensation scheme is remote. It follows that the likelihood that the loss of access to such a scheme will be detrimental to them is also remote.

9.44 Given the remoteness of the scenario where compensation is required by the transferring policyholders and that the majority of policyholders in the Transferring Portfolio are not eligible for FSCS protection, I believe the actual detriment to transferring policyholders from losing access to the FSCS to be less material than the potential impact to these policyholders should the Scheme not go ahead.

Conclusions

9.45 In my opinion the Scheme will not have a material adverse impact on the security of the transferring policyholders, including under insolvency, for the following reasons:

- They will be transferring from an entity with an SCR coverage ratio lower than the entity they are transferring into following the Scheme.
- Given that both AIUK and AIEU benefit from an 85% intercompany quota share agreement with ARL, the transferring policyholders will continue to benefit from this protection after the transfer. As I concluded in paragraph 9.22, I am satisfied that the Scheme will not have a material detrimental impact on the security provided under the IQS to the policyholders of the Transferring Portfolio, despite the fact that they will cease to benefit from the trust fund collateral.
- Whilst AIEU's Own Funds are lower than AIUK's Own Funds in absolute terms, all of AIEU's Own Funds are Tier 1 whereas 10.3% of AIUK's Own Funds are Tier 2 Own Funds.
- I am of the opinion that AIEU will be sufficiently capitalised in order to meet policyholder obligations over the course of the run-off of the Transferring Portfolio and the Existing AIEU Portfolio. This opinion is based on my analysis of the solvency position of AIEU after the Scheme and the stress testing performed in Section 8, and allows for the capital injection of £8.9m into AIEU from the Arch Group prior to the Effective Date.
- I also assessed the impact from the scenario where the Arch Group does not inject additional capital of £8.9m into AIEU prior to the Effective Date. Based on my analysis that I discussed in paragraph 8.232, I am of the opinion that the probability of AIEU's assets falling below its liabilities in this scenario remains unlikely.
- As stated in paragraph 5.20, the majority of policyholders in the Transferring Portfolio are direct insurance contracts and will therefore have preferential access to any remaining funds in the event of insolvency both before and after the Scheme.
- No policyholders are expected to lose access to the FSCS as a result of the Scheme.

9.46 Based on these considerations, I believe the likelihood of AIEU encountering significant financial difficulties to be remote. Consequently, I conclude that the Scheme will not have a material adverse impact on the security of the transferring policyholders.

9.47 Please note that this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

Impact of the Scheme on the security of policyholders remaining in AIUK

9.48 In my opinion the Scheme will not have a material adverse impact on the security of the policyholders remaining in AIUK, including under insolvency, for the following reasons:

- AIUK's SCR coverage ratio is positively impacted as a result of the Scheme.
- I am of the opinion that AIUK will be sufficiently capitalised in order to meet policyholder obligations. This opinion is based on my analysis of the solvency position of AIUK after the Scheme and the stress testing performed in Section 8

- There will be no change in the insolvency regulations for policyholders remaining within AIUK as a result of the Scheme since they will be subject to the UK insolvency regulations both before and after the Scheme.
- Furthermore, following the Scheme, there will be no change to the compensation available to policyholders remaining in AIUK in the event of the insolvency of AIUK as policyholders that are eligible for FSCS protection prior to the Scheme will continue to be eligible following the Scheme.
- As I concluded in paragraph 9.22, I am satisfied that the underlying assets of the trust fund which protect the IQS are sufficient to enable the IQS to meet its obligations.

Impact of the Scheme on the security of the existing policyholders in AIEU

9.49 In my opinion the Scheme will not have a material adverse impact on the security of the existing AIEU policyholders, including under insolvency, for the following reasons:

- With the exception of Scenario 2 in Table 9.3 where the SCR coverage ratio for AIEU increases as a result of the Scheme, the SCR coverage ratio is likely to decrease slightly as a result of the Scheme, however, the reduction is small and the Scheme also results in a small increase in the absolute value of Own Funds in excess of the SCR.
- AIEU's insurance liabilities will increase significantly following the Scheme as the insurance liabilities from the Transferring Portfolio will move to AIEU from AIUK. However, AIEU will also hold more capital following the Scheme to allow for the increase in its insurance liabilities. I am of the opinion that AIEU will have sufficient capital in order to meet its policyholder obligations over the course of the run-off of the Transferring Portfolio and the Existing AIEU Portfolio. This opinion is based on my analysis of the solvency position of AIEU after the Scheme and the stress testing performed in Section 8.
- Allowing for the £8.9m capital injection into AIEU from the Arch Group prior to the Effective Date, I am also of the opinion that AIEU will be sufficiently capitalised in order to meet policyholder obligations over the course of the run-off of the Transferring Portfolio and the Existing AIEU Portfolio under each of the three Scenarios that I considered in paragraphs 9.15 to 9.20
- I also assessed the impact from the scenario where Arch Group does not inject additional capital of £8.9m into AIEU prior to the Effective Date. Based on my analysis that I discussed in paragraph 8.232, I am of the opinion that the probability of AIEU's assets falling below its liabilities in this scenario remains unlikely.
- There will be no change in the insolvency regulations for the existing policyholders of AIEU as a result of the Scheme since they will be subject to the Irish insolvency regulations both before and after the Scheme.
- Furthermore, following the Scheme, there will be no change to the compensation available to the existing policyholders of AIEU in the event of the insolvency of AIEU as policyholders that are eligible for ICF protection prior to the Scheme will continue to be eligible following the Scheme.

10 Other financial considerations

10.1 In this section, I discuss the following items in turn:

- Financial impact of COVID-19
- Investment strategy
- Liquidity position
- Implications of the Scheme on ongoing expense levels
- Pension arrangements
- Tax implications
- Impact on transferring reinsurers
- Impact of new business strategy
- Impact of other transfers

Financial impact of COVID-19

10.2 There is substantial uncertainty in the financial impact from COVID-19 on AIUK and AIEU. To consider the potential downside risk from this event, I have stress tested a very pessimistic but plausible scenario and the impact from this scenario on the solvency positions of AIUK and AIEU.

10.3 In this report, I have considered the financial impact of COVID-19 on AIUK and AIEU as summarised below:

- In paragraphs 7.69 to 7.90, I consider the impact on AIUK's and AIEU's reserves
- In paragraphs 8.38 to 8.53, I consider the impact on AIUK's projected SCR and Own Funds at the Effective Date
- In paragraphs 8.88 to 8.93, I consider the impact to AIUK's solvency position under a very pessimistic but plausible scenario where COVID-19 gives rise to significant further losses due to loss of business volumes, increase in claims, investment losses and exchange rate losses
- In paragraphs 8.146 to 8.156, I consider the impact on AIEU's projected SCR and Own Funds at the Effective Date
- In paragraphs 8.193 to 8.198, I consider the impact to AIEU's solvency position under a very pessimistic but plausible scenario where COVID-19 gives rise to significant further losses due to loss of business volumes, increase in claims, investment losses and exchange rate losses

10.4 Given the uncertainty that currently attaches to COVID-19, it remains possible that the adverse impact in one or more areas could ultimately be more severe than that assumed n my a very pessimistic but plausible scenario. Given the information currently available, I believe that this scenario is a reasonable representation of a very pessimistic but plausible outcome. Nevertheless, I will revisit my assessment of the impact from COVID-19 and my very pessimistic but plausible scenario in my Supplementary Report in order to take account of any further developments relating to this event.

Investment strategy

Investment strategy of AIUK

10.5 AIUK's investment objective is to preserve capital, provide liquidity and provide a return that meets or exceeds the total return of assigned benchmarks for each of AIUK's portfolios. The responsibility for monitoring objectives and assessing the ultimate adequacy of the investment strategy lies with AIUK's Board.

10.6 I understand from AIUK that it has a relatively short-dated, low risk asset portfolio whereby investments are predominately in government and corporate bonds, with some investments in cash. The majority of bonds are held in companies or institutions that are readily traded, i.e. there is an active market and, at purchase, securities must be rated BBB- or higher by a major rating organisation. I understand from AIUK that, subsequent to purchase, downgrades to ratings below BBB- will be assessed by AIUK for divestment on a case by case basis.

10.7 AIUK's investment portfolio by currency is as follows:

- 85.5% of the investments are denominated in British Sterling
- 10.5% of the investments are denominated in US Dollars
- 3.3% of the investments are denominated in Euro
- 0.7% of the investments are denominated in Australian Dollars.

10.8 As at 31 December 2019, AIUK's Solvency II returns showed that 31.3% or £33.6m was invested in equities. However, AIUK's equity investment is in respect of AEIS, which on a Solvency II basis is accounted for as an equity investment. There were no other equity investments reported on AIUK's Solvency II Balance Sheet at that date. AEIS is not an exchange traded security and therefore I do not believe it to be a liquid investment. For the purpose of my analysis, I have considered AIUK's holdings in AEIS's to be a feature of its corporate and operational structure and I have not considered it to be a component of AIUK's investment strategy.

10.9 I understand from AIUK that, apart from its investment in AEIS which, as mentioned above, is treated as an equity investment from a Solvency II perspective, AIUK has limited appetite for investing in equities. I further understand from AIUK that it has a limited appetite for alternative investment products, property or any other investment classes.

10.10 AIUK has informed me that its investment strategy, and implementation thereof, is not expected to change following the Scheme.

Investment strategy of AIEU

10.11 AIEU's investment objective is to provide a total return in its portfolio that exceeds the total return of its assigned benchmark. AIEU's current investment policy (that is, prior to the Scheme) stipulates that all investments must be made in securities denominated in US Dollars.

10.12 AIEU is currently invested in a diversified portfolio of short-term debt instruments, fixed income government and corporate bonds, equities, cash and cash equivalents.

10.13 As at 31 December 2019, AIEU's Solvency II net technical provisions were valued at £8.8m of which £8.2m were denominated in Euro, £0.6m were denominated in US Dollars and £1.6m were denominated in other currencies. By comparison, AIEU's Solvency II balance sheet showed that its investments at the same date were valued at £66.0m. All of AIEU's investments were denominated in US Dollars which means that there is a currency mismatch between AIEU's investments and its liabilities,

10.14 AIEU has informed me that this mismatch is due to the strategy of ACGL AIEU's ultimate parent group. Although the currency mismatch attracts a higher regulatory capital charge, AGCL has balanced the cost from this strategy against its overall objective to reduce the volatility in its US Dollar returns. ACGL's shares are denominated in US Dollars and ACGL's investment strategy seeks to minimise the volatility in US Dollar returns experienced in order to help to minimise the volatility experienced by its shareholders. For this reason, capital provided to AIEU has historically been denominated in US Dollars.

10.15 AIEU has informed me that, following the Scheme, its Board has agreed to invest the transferring funds in Euro-denominated assets of a similar type and quality to its current US-denominated investments and that there will be no change to the mix or strategy for AIEU's existing investment portfolio prior to the Scheme. AIEU has informed me that this proposal has been approved by its Board.

10.16 In paragraphs 8.157 to 8.162, I discussed AIEU's estimated Solvency II Balance Sheet at the Effective Date prior to and following the Scheme. I have calculated from this estimated Solvency II Balance Sheet that the value of AIEU's investments following the Scheme will be 3.5 times the value of its net technical provisions. Based on this multiple, my opinion is that the likelihood of a deterioration in the US Dollar that is severe enough to result in AIEU having insufficient investments to meet its net technical provisions following the Scheme is remote. Nevertheless, the currency mismatch exposes AIEU to a greater level of currency risk than AIUK. However, this additional risk is compensated for through AIEU's SCR requirement and AIEU's capital requirement in respect of Market Risk will reflect the additional risk it is taking on in comparison to AIUK.

10.17 I understand from AIEU that it currently has no appetite for new investments in securitisations and its investment policy does not permit this. However, securitisations purchased prior to 2019 may be held to maturity. I discuss these investments further in paragraph 10.39

10.18 AIEU has a greater proportion of its portfolio invested in corporate bonds and a smaller proportion invested in government bonds compared to AIUK. AIEU's corporate bonds portfolio also has a greater proportion invested in bonds with a lower credit rating compared to AIUK. Therefore, I consider AIEU's bond portfolio, in aggregate, to be more risky than AIUK's bond portfolio. However, this additional risk is compensated for through AIEU's SCR requirement and AIEU's capital requirement in respect of Market Risk will reflect the additional risk it is taking on in comparison to AIUK.

10.19 AIEU also has a greater proportion of its portfolio invested in securitisations compared to AIUK. Therefore, I consider this aspect of AIEU's asset portfolio, to be more risky than AIUK's asset portfolio. However, this additional risk is compensated for through AIEU's SCR requirement and AIEU's capital requirement in respect of Market Risk will reflect the additional risk it is taking on in comparison to AIUK.

10.20 As at 31 December 2019, AIEU's Solvency II returns showed that none of its funds were invested in equities and that all of AIEU's fixed income investments had a credit rating between BBB+ and AAA. I have been informed by AIEU that it will hold a similar proportion of assets in highly rated debt instruments following the Scheme.

Investment management

10.21 While AIUK and AIEU each have individual investment objectives that are approved by their respective Boards, both entities' investment strategies conform to ACGL's overall investment strategy.

10.22 The investment portfolios of AIUK and AIEU are both managed by Arch Investment Management Limited ("AIML"), which is a sister company of ACGL. I understand from AIUK and AIEU that AIML invests AIUK's and AIEU's investment portfolios in accordance with the investment guidelines that have been set by each of these entities. I understand that each investment guideline takes into account the investment strategy, risk profile and capital needs of the respective entity.

10.23 I have been informed by AIUK and AIEU that AIML is aware of the Scheme and that it is working with AIUK and AIEU to adjust the investment guidelines it applies to the AIUK and AIEU portfolios to reflect the Scheme where needed.

10.24 I understand from AIUK and AIEU that AIML communicates with the managements of AIEU and AIUK on a regular basis, and that any changes to investment guidelines are subject to approval either by Board members or the investment committees of AIUK and AIEU.

Impact on policyholders

10.25 As I discussed in paragraph 10.13, AIEU's investment strategy results in a higher level of currency mismatch than AIUK's investment strategy. From paragraph 10.18, I observe that AIEU has a greater proportion of its portfolio invested in corporate bonds and a smaller proportion invested in government bonds compared to AIUK. Of the two investment portfolios, a greater proportion of AIEU's bond portfolio is also invested in lower credit-quality corporate bonds than AIUK. Based on these observations, I am of the opinion that AIEU is exposed to a greater degree of Market Risk in comparison to AIUK.

10.26 However, I consider the higher risk in AIEU's investment strategy to be sufficiently compensated for. In reaching this conclusion I have considered the following:

- As I concluded in paragraph 8.218, I consider that AIEU will have sufficient assets to meet its liabilities in all reasonably foreseeable deteriorations in the value of its investment portfolio.
- As I discussed in paragraph 10.18, this additional risk is accounted for in AIEU's regulatory capital requirements via a higher Market Risk capital requirement. I therefore consider AIEU to hold a sufficient level of capital and therefore consider the higher risk in its investment strategy to be sufficiently compensated for.

10.27 In order to reduce the assets below the liabilities, AIEU would need to experience a reduction in the value of its investments in the region of 80% Given this, my opinion is that I consider AIEU to have sufficient assets to meet its liabilities in all reasonably foreseeable scenarios.

10.28 I therefore do not consider that moving from being exposed to AIUK's investment strategy to being exposed to AIEU's investment strategy will have a material adverse impact on the transferring policyholders.

10.29 There will be no change to the investment strategy that the policyholders remaining in AIUK are exposed to as a result of the Scheme.

10.30 There will be no changes to the investment strategy that the existing AIEU policyholders are exposed to as a result of the Scheme other than those I set out in paragraph 10.15. As these changes will not lead to an increase in the volatility of AIEU's investments but will reduce AIEU's currency mismatch risk, I do not believe that these changes will have a material adverse impact on the AIEU's Existing Policyholders.

Liquidity position

10.31 I have reviewed the risk appetite statements, asset allocation and investment risk policies of both AIUK and AIEU.

AIUK

10.32 AIUK defines liquidity risk as the risk that it is unable to realise its investments and other assets in order to settle its financial obligations when they fall due. I understand that other than insurance liabilities, AIUK's main operating liabilities consist of acquisition commission, operating expenses and corporate taxes.

10.33 AIUK's liquidity risk appetite statement sets out the limits and tolerances in respect of the percentage of its assets that will be invested in liquid investments and its investment risk policy sets out the processes that AIUK implements to monitor and ensure compliance with its liquidity risk appetite.

10.34 AIUK also manages its liquidity risk through its intragroup quota share reinsurance arrangement with Arch Re Ltd. Under this quota share arrangement, AIUK cedes 85% of its gross risk which reduces the amount that AIUK would have to pay in the event of a claim by 85%. I understand that recoveries due under this quota share are settled quarterly in arrears in order to increase the certainty around the timing of payments due from the reinsurer and to reduce the liquidity risk faced by AIUK in the event of a large claim.

10.35 As at 31 December 2019, approximately 22.0% of AIUK's investments on a Solvency II basis were in cash and 64.6% were in corporate and government bonds. The average duration of its assets was 2.61

years compared to an average duration of its liabilities of 2.22 years. I understand from AIUK that its asset allocation and investment strategy will not change materially as a result of the Scheme.

10.36 From paragraph 10.35, I observe that 86.6% of AIUK's investments are held in either cash or highly liquid exchange traded securities, and I also note that additional liquidity provided by AIUK's 85% quota share arrangement with Arch Re Ltd, discussed in paragraph 10.34, Based on this, I consider AIUK to have sufficiently liquidity to meet its liabilities as they fall due.

AIEU

10.37 AIEU defines liquidity risk in the same way as AIUK as set in in paragraph 10.32 above. In addition, AIEU has also set out equivalent limits, tolerances and processes to AIUK in its liquidity risk appetite statement and investment risk policy.

10.38 Similar to AIUK, AIEU also has an 85% intragroup quota share reinsurance arrangement with Arch Re Ltd. I understand that recoveries due under this quota share are also settled quarterly in arrears based on amounts booked in prior quarters, on the basis of ceded premium written minus the sum of ceded commissions and ceded paid claims. This is to increase the certainty around the timing of payments due from the reinsurer and to reduce the liquidity risk faced by AIEU in the event of a large claim.

10.39 As at 31 December 2019, approximately 6.7% of AIEU's total investments on a Solvency II basis were in cash and money-market funds, 85.9% were in corporate and government bonds, and 7.7% were in derivatives and asset-backed securities. The average duration of its assets was 3.37 years compared to an average duration of its liabilities of 4.27 years. I understand from AIEU that its asset allocation and investment strategy will not change materially as a result of the Scheme other than the changes I set out in paragraph 10.15.

10.40 From paragraph 10.39, 92.6% of AIEU's investments are held in either cash or bonds. Based on this, and the liquidity provided to AIEU under its quota share arrangement with Arch Re Ltd, I consider AIEU to have sufficiently liquidity to meet its liabilities as they fall due.

Impact on policyholders

10.41 Based on consideration of the above, I believe both AIUK and AIEU to have sufficiently liquid assets and therefore I do not anticipate that the Scheme will create any material adverse impact with respect to liquidity for the transferring policyholders, the policyholders remaining within AIUK or the existing policyholders of AIEU.

Implications of the Scheme on ongoing expense levels

10.42 Other than the initial costs of the Scheme to AIUK, namely professional fees and the costs in respect of the policyholder communications required under the Scheme, I understand that there are no additional expenses anticipated in relation to the Remaining Portfolio as a result of the Scheme. AIUK has provided me with an estimate of these initial costs which I have compared to the estimated profits for the 2020 from AIUK's ORSA. Based on this comparison, in my view the initial cost of the Scheme is immaterial in the context of AIUK's overall business and therefore it will not impact the security of the remaining AIUK policyholders.

10.43 To satisfy myself that AIEU has sufficient financial and operational resource to deal with any changes to ongoing expense levels, I have considered the following:

- AIUK has provided me with the split of ULAE on a Solvency II basis between the Remaining Portfolio and the Transferring Portfolio. As I concluded in paragraph 10.27, I consider AIEU to have sufficient assets to meet its liabilities in all reasonably foreseeable scenarios. These liabilities, on a Solvency II basis, include ULAE. Therefore, while there are expenses arising as a result of the Scheme, I am comfortable that these have been sufficiently considered within the Technical Provisions and that there are sufficient assets to cover these expenses.

- From an operational perspective, AIEU does not anticipate changes to senior staff or number of employees as a result of the Scheme, although it has acknowledged the likelihood of an increase in the time allocated to AIEU by AEIS's staff.
- As I discussed in paragraphs 5.45 and 5.46, AEIS UK staff commenced providing services to AIEU in 2019 to support its P&C Division, as well as continuing to support policies in the Transferring Portfolio. I understand that, following the Effective Date, the same AEIS UK staff will continue to service policies in the Transferring Portfolio on the same terms as the service and secondment arrangements already in place between AIEU and AEIS.
- AIEU's P&C Division was historically underwritten by AIUK; however, since 1 January 2020, renewing policies within AIUK's portfolio have been underwritten by AIEU instead. However, AIEU has informed me that there are some transferring coverholders whom AIEU have not had prior relationships with, such as coverholders written by AIUK prior to 2019 and which were not renewed in 2019. Nevertheless, AIEU has existing relationships with most of the coverholders from the Transferring Portfolio and no material operational changes are anticipated in order to work with additional coverholders.
- Therefore, the systems, structures and operations currently in place, will not materially change as the volume of business taken on following the Scheme increases.

10.44 AIEU has further informed me that it does not envisage needing significant additional resources to be able to manage the Transferring Portfolio and there will be no transfer of employees from AIUK to AIEU as a result of the Scheme. AEIS currently provides a significant proportion of the resources required to manage the Transferring Portfolio. AIEU has informed me that no change is envisaged to the individuals within AEIS that are responsible for managing the Transferring Portfolio as a result of the Scheme however it does anticipate an increase in the level of the service charges that AEIS will allocate to AIEU. I understand from AIEU that an estimate of the additional charges that AEIS will have to pay in the future is included within the ULAE component of its net technical provisions transferring under the Scheme. As the net technical provisions transferring under the Scheme will be offset by a transfer of investments from AIUK to AIEU, I do not believe that the additional services charges will materially adversely impact on the Existing Policyholders or the Transferring Policyholders.

10.45 Even in the event of a longer than expected run-off of the liabilities, following my assessment of the solvency of AIEU and the stress testing performed in Section 8, I consider that AIEU will still be sufficiently capitalised in order to meet its obligations over the entirety of the run-off of the liabilities.

10.46 Based on consideration of the above, I do not anticipate that the Scheme will create any material adverse impact with respect to on-going expense levels for the transferring policyholders, the policyholders remaining within AIUK or the existing policyholders of AIEU.

Pension arrangements

10.47 I have been informed by AIUK and AIEU that there will be no material changes to staff pension schemes as a result of the Scheme.

10.48 In addition, having assessed the impact of the Scheme on the balance sheets of both AIUK and AIEU in Section 8, I do not consider that the Scheme will have any material adverse impact on either AIUK or AIEU's ability to fund their staff pension schemes following the Scheme.

10.49 Consequently, I do not anticipate that the Scheme will create any material adverse impact with respect to pension arrangements for the transferring policyholders, the policyholders remaining within AIUK or the existing policyholders of AIEU.

Tax implications

10.50 AIUK and AIEU have both informed me that they do not consider that there are likely to be any material tax implications as a result of the Scheme. In addition, AIUK provided me with an internal memorandum summarising ACGL's analysis of the tax implications for AIUK and AIEU as a result of the Scheme.

10.51 I have shared ACGL's analysis with the tax experts at Grant Thornton who specialise in the insurance sector, and taken advice from them. They have reviewed the information provided to me and do not believe there to be any material tax implications that affect the Scheme.

Impact on existing co-insurers

10.52 There are a number of policies within the Transferring Portfolio which feature co-insurance arrangements, with AIUK historically participating in a share of these risks. AIUK has informed me that these arrangements are on a limited-liability basis; that is, the failure of either AIUK or a co-insurer to pay claims as they fall due does not impact the exposure of the other parties.

10.53 Consequently, I do not expect that these co-insurers will be adversely impacted by the Scheme. It follows from this that I do not expect that these co-insurers will be materially disadvantaged by the Scheme.

Impact on transferring reinsurers

10.54 AIUK ceased writing new business in the EEA since 1 January 2020, other than a small book of 40 policyholders, and the other non-UK EEA policies that would have historically been written by AIUK have since been written AIEU within its P&C Division. The business within the AIEU's P&C Division is similar to that of the Transferring Portfolio. It covers the same lines of business and has been sourced through the same coverholders and intermediaries.

10.55 In addition, AIEU currently shares in AIUK's reinsurance programme and has the same reinsurance protections in respect of the Transferring Portfolio as AIUK. The reinsurers transferring under the Scheme therefore currently already transact with AIEU and the transferring reinsurers therefore will not be entering into a relationship with a new cedent as a result of the Scheme.

10.56 In addition, as the Transferring Portfolio comprises of business that was underwritten prior to 1 January 2020 only, the Scheme will not change the underlying risks that the transferring reinsurers are exposed as the business would have already been underwritten at the Effective Date.

10.57 In addition, from my stress testing analysis in paragraph 8.228, I concluded that AIEU will be adequately capitalised following the Scheme. Given this, I do not expect that Scheme to materially increase the credit risk that the transferring reinsurers are exposed to.

10.58 Based on my conclusions in paragraphs 10.55 to 10.56, I do not expect that transferring reinsurers will be materially disadvantaged by the Scheme.

Impact of new business strategy

10.59 AIUK ceased writing new business in the EEA since 1 January 2020 AIUK, other than a small book of 40 policyholders, and the other non-UK EEA policies that would have historically been written by AIUK have since been written AIEU instead. This change has been taken into account in AIUK's and AIEU's business plans for 2020 and future years. This change has been allowed for my analysis of the impact of the Scheme on policyholder security at the Effective Date in section 9 of this report.

Impact on policyholders remaining within AIUK

10.60 AIUK has informed me that its new business strategy will not change as a result of the Scheme. It follows that, in my opinion, the Scheme will not have any material adverse impact on the policyholders remaining in AIUK in relation to the new business strategy that they are exposed to.

Impact on existing policyholders within AIEU

10.61 AIEU has informed me that its new business strategy will not change as a result of the Scheme. It follows that, in my opinion, the Scheme will not have any material adverse impact on the policyholders remaining in AIEU in relation to the new business strategy that they are exposed to.

Impact on the transferring policyholders

10.62 Although AIUK and AIEU have different new business strategies, I do not envisage that this will have a material adverse impact on the transferring policyholders for the following reasons:

- AIUK is authorised by the PRA and regulated by the PRA and FCA
- AIEU is authorised and regulated by the CBI
- AIUK and AIEU are members of the same group of companies and as a result have very similar business objectives
- Both AIUK and AIEU hold capital to support the risks that they are exposed to. In addition, as concluded in Section 8, I am of the opinion that both companies have sufficient capital to meet policyholder obligations
- As I conclude in paragraph 11.53 below, both AIUK and AIEU have appropriate management frameworks in place to support their respective businesses.

Impact of other transfers

10.63 At the time of writing this Report, AIUK has informed me that there are no other transfers to or from AIUK that are expected to take place.

10.64 AIEU has informed me that, in addition to the Transferring Portfolio, it has identified two other potential portfolio transfers from Alwyn Insurance Company Limited and Watford Insurance Company Europe Limited. Should these take place, they are expected to be transferred towards the end of the 2022.

10.65 In considering these transfers, AIEU has set out the Solvency II Technical Provisions as at 30 September 2019 for both potentially transferring portfolios. At this date, the technical provisions net of reinsurance, including quota share protections issued by Arch Reinsurance Ltd. and Watford Re Ltd., for both potentially transferring entities at 30 September 2019 were valued at a total of £7.9m. In comparison, AIEU's estimated net technical provisions at 31 December 2019 following the Scheme were £37.6m. However, AIEU has stated that both potentially transferring portfolios are currently in run-off. Therefore, should these potential transfers take place, the net technical provisions are expected to be lower than £7.9m at the transfer date.

10.66 The business transferring from Alwyn Insurance Company Limited and Watford Insurance Company Europe Limited benefits from significant reinsurance protection including an intragroup quota share issued by Arch Reinsurance Ltd. and Watford Re Ltd. which will reduce the impact of this transfer on AIEU's capital requirement. AIEU has also informed me that should this transfer take place, it expects that in addition to the liabilities, sufficient funds would be transferred to allow AIEU to maintain a similar capital coverage ratio following this transfer.

10.67 Therefore, I do not anticipate that either of these transfers will create any material adverse impact on the transferring policyholders, the policyholders remaining with AIUK or the existing policyholders of AIEU, with respect to the Scheme.

11 Other non-financial considerations

11.1 In this section, I discuss the following items in turn:

- Regulatory jurisdiction
- Claims handling and policy administration
- Complaints
- The recognition of the Scheme in other jurisdictions
- Governance and management frameworks
- ‘Brexit’
- Ruling of Mr Justice Snowden on the proposed Part VII transfer of a book of in-payment annuities from The Prudential Assurance Company Limited to Rothesay Life Plc
- Non-financial impact of COVID-19
- The impact on policyholders should the Scheme not become effective.

Regulatory jurisdiction

11.2 For the Transferring Portfolio, the prudential regulation will move to the CBI from the PRA. The impact of this change in terms of policyholder security will be immaterial as both regulators are required to operate in line with Solvency II, the common prudential regulatory framework across the EU. At the Effective Date, Solvency II regulations still apply to UK insurers, despite the UK having left the EU as the Effective Date is the currently agreed final day of the Brexit transition period.

11.3 In preparation for the UK’s withdrawal from the EU, the UK Parliament approved the European Union (Withdrawal) Act 2018 (“the Act”). The Act’s primary purpose is to provide legal continuity to the UK following its departure from the EU. The Act transposes applicable EU laws (including those relating to Solvency II) into UK law giving rise to a new category of domestic law for the United Kingdom referred to as “retained EU law". However, the Act also gives the UK government and governmental bodies some restricted power to adapt and remove retained EU laws and regulations that are no longer considered to be relevant.

11.4 Although the UK will have the ability to change its local laws and regulations following the Brexit transition period, changes are likely to take place gradually over time. The Chancellor of the Exchequer announced on 23 June 2020 that the UK Government intends to bring forward a review of certain features of Solvency II to ensure that it is properly tailored to take account of the structural features of the UK insurance sector. In his statement, the Chancellor said that the review will consider areas that have been the subject of long-standing discussion while the UK was a Member State of the EEA including, but not limited to, the risk margin, the matching adjustment, the operation of internal models and reporting requirements for insurers. At the time of this report, it is too early to predict the conclusions of this review or the timing or details of any resulting changes in the regulation of UK insurers.

11.5 In the event that the UK Government introduces rules which result in a material strengthening of the financial security of UK insurers, the transferring policyholders might have been better off in terms of security had they remained in AIUK. However, as discussed above, there is a risk that AIUK could lose its passporting rights and that, if these policyholders remain in AIUK, they could find themselves with an insurer who is unable to service their policies or pay their claims. In addition, as discussed in sections 8 and 9 of this report, it is my opinion that these policyholders will be moving to an entity that is adequately capitalised. On balance, I believe that any potential detriment to these policyholders should the financial security of UK insurers be strengthened following Brexit is outweighed by the risk of AIUK losing its right to provide insurance cover to them.

11.6 Regardless of the changes that the UK Government introduces, I would not expect this to affect my conclusions for the policyholders of the Remaining Portfolio because, the regulatory jurisdiction for these policyholders will not change as a result of the Scheme and these policyholders would be subject to UK regulations and any future changes made to UK regulations whether or not the Scheme went ahead.

11.7 Similarly, for the policyholders of the Existing Portfolio, the regulatory jurisdiction will not change as a result of the Scheme and these policyholders would not be subject to UK regulations whether or not the Scheme went ahead.

11.8 From a conduct perspective, the Transferring Portfolio is currently regulated by a combination of the FCA (in the capacity of the home state regulator), the CBI and various other EEA regulators corresponding to the EEA states in which the risks are located and the EEA states in which the policies have been sold. Following the Scheme, the FCA will be replaced by the CBI as the home state regulator in respect of the Transferring Portfolio. As the CBI has mature and established conduct regulatory frameworks, I do not expect the change in the home state regulator to have a material detrimental impact on the transferring policyholders.

11.9 For the policies written in EEA countries other than Ireland, there will be no change in the supervision provided by the regulator in that country following the Scheme.

11.10 For the Remaining Portfolio, regulation is currently provided by the PRA and FCA and will remain so following the Scheme.

11.11 For the Existing AIEU Portfolio, regulation is currently provided by the CBI and will remain so following the Scheme.

11.12 Therefore, my opinion is that I do not expect any group of policyholders to be materially adversely affected in relation to regulatory jurisdiction as a result of the Scheme.

Claims handling and policy administration

11.13 I have been provided with the Arch Insurance International Claims Manual which AIUK uses as its claims handling policy document, dated May 2019, and AIEU's latest claims handling policy document, dated May 2020. Having reviewed these, I do not consider the processes incorporated by AIEU for its claims handling procedures to be unreasonable or so different as to provide any material detriment between policyholders belonging to either AIUK or AIEU.

11.14 I have been informed by AIUK and AIEU that there are not expected to be any material changes in the claims handling and policy administration processes for the Transferring Policyholders as a result of the Scheme.

11.15 Before the Scheme, for both the Remaining Portfolio and the Transferring Portfolio, claims are managed primarily by the coverholders that sold the policy or by third party administrators ("TPAs") appointed to handle the claims under a delegated claims authority. Claims which exceed the delegated claims authority given to the coverholder or TPA (I understand from AIUK that this varies but 100,000 in the local currency equivalent of Euro, Pound Sterling or US Dollar is typical) are referred to the AIUK claims team for oversight and monitoring. All claims above $500,000 (or $250,000 for lines of business where cover is provided to Small and Medium Enterprises (SMEs)) are subject to review and approval by AIUK's claims department, under the services agreement with AEIS, and AIUK's Head of Claims. These claims make up a relatively small proportion of the claims within the Remaining and Transferring Portfolios.

11.16 Following the Scheme, for the Transferring Portfolio, claims will continue to be managed primarily by the coverholders that sold the policy or appointed TPAs. Therefore, for the significant majority of claims, there will be no change in the claims handling process. I have also been informed by AIEU that AEIS's claims personnel will continue to oversee and monitor claims which exceed the delegated claims authority.

11.17 Although the overall responsibility for review and approval of claims from the Transferring Portfolio will transfer to AEIS's claims department and Head of Claims following the Scheme, I do not believe that this will materially affect the Transferring Policyholders. As I discussed in paragraph 11.13, AIEU has an equivalent claims department to AIUK and has a broadly equivalent claims handing policy. In addition, AEIS's claims personnel will continue to oversee and monitor claims that are large or require specialist knowledge.

11.18 Following the Scheme for the Remaining Portfolio, AIUK have informed me that there will be no change to the claims handling process.

11.19 AIEU have informed me that there will be no change to the claims handling process in respect of the Existing Portfolio following the Scheme.

11.20 Based on the above, I do not anticipate that any changes to the claims handling provided following the Scheme will have a material adverse impact on the Remaining Policyholders, Transferring Policyholders or Existing Policyholders.

Complaints

Transferring Portfolio

11.21 AIUK is currently responsible for complaints handling for the Transferring Portfolio, following the Scheme, this responsibility will transfer to AIEU.

11.22 I have been provided with AIUK's complaints handling policy document, dated November 2018, and AIEU's complaints handling policy document, dated October 2018. Having reviewed these, I do not consider either policy to be unreasonable. Furthermore, I do not consider the processes followed by AIEU for its complaints handling procedures to be so different to that followed by AIUK as to provide any material detriment between policyholders belonging to either AIUK or AIEU.

11.23 I understand from AIUK that the Transferring Portfolio includes policies held by policyholders who have rights of access to the Financial Ombudsman Service ("FOS") for complaints adjudication. AIUK has informed me that Transferring Policyholders who are domiciled in the EU (apart from the UK) and who currently have access to the FOS will retain access to FOS in respect of any complaint that might arise in respect of a past policy where AIUK was the insurer. However, AIUK has also informed me that such policyholders will lose access to the FOS, but will retain access to the Irish equivalent, the Financial Services and Pensions Ombudsman ("FSPO") in respect of any policies where AIEU is the insurer.

11.24 The monetary limits for a claim under the FSPO are €500,000 (or €52,000 p.a. for annuity claims) as opposed to amounts between £150,000 and £355,000 under FOS, depending on when the act complained about occurred and the complaint was brought. Such policyholders would also maintain access to the equivalent scheme via the European network of alternative dispute resolution schemes, FIN-NET, I discuss FIN-NET in further detail in paragraphs 11.29 and 11.30.

11.25 FOS is a free service for consumers that provides an out-of-court adjudication service for consumer complaints. FOS is able to make decisions that are binding on the insurer in relation to the complaints it considers; these decisions can include redress and remediation.

11.26 Similarly to FOS, FSPO is a free service for consumers that provides an out-of-court adjudication service for consumer complaints. FSPO is able to make decisions that are binding on the insurer in relation to the complaints it considers, these decisions can include redress and remediation.

11.27 Eligible claimants for the FOS are defined to be:

- Consumers, which for these purposes means natural persons acting for purposes outside their trade, business or profession
- Micro-enterprises, which means any business which:
  - has a turnover or annual balance sheet that does not exceed €2 million
  - employs fewer than 10 persons
- Small business, which means an enterprise which:
  - Is not a micro-enterprise
  - has an annual turnover of less than £6.5 million
  - has a balance sheet total of less than £5 million, or employs fewer than 50 employees
- Charities which have an annual income of less than £6.5 million
- Trusts with a net asset value of less than £5 million
- Individuals who act as personal guarantors for loans to businesses they are involved in.

11.28 To be eligible claimants for the FSPO in Ireland, the policyholder must be a policyholder with an insurer that is registered with or authorised by the CBI. Eligible claimants, subject to limitations on turnover, for the FSPO in Ireland are defined to be:

- Private individuals
- Limited companies
- Sole traders
- Trusts
- Clubs
- Charities
- Partnerships.

11.29 In addition to the FSPO, policyholders may also be able to refer complaints to the ombudsman service in their country of domicile, as long as it is a member of FIN-NET.

11.30 FIN-NET was set up by the European Commission in 2001 to promote cooperation among national ombudsmen in financial services and provide consumers with easy access to alternative dispute resolution procedures in cross-border disputes regarding the provision of financial services. FIN-NET is a network of national organisations responsible for settling consumers' complaints in the area of financial services out of court. The network covers all EEA countries.

11.31 I understand from AIUK that it has reviewed the Transferring Policies and has not identified any policyholders that meet FOS's eligibility criteria but do not meet FSPO's eligibility criteria. As a result, I do not believe the loss of access to FOS will have a material adverse impact on these policyholders as these policyholders will continue to have access to the FSPO which also offers a free service and is an equivalent ombudsman in terms of scope and authority to issue binding decisions.

Remaining Portfolio

11.32 AIUK has informed me that there will be no change to its complaints handling processes as a result of the Scheme. As the remaining policyholders will remain insured by a UK insurer, there will also be no change in their access to the FOS as a result of the Scheme. As a result, I do not believe that the remaining policyholders will be materially adversely affected by the Scheme in relation to the handling of complaints.

Existing Portfolio

11.33 AIEU has informed me that there will be no change to its complaints handling processes as a result of the Scheme. As the existing policyholders will continue to be insured by an insurer that is authorised by the CBI, there will also be no change in their access to the FSPO as a result of the Scheme. As a result, I do not believe that the existing policyholders will be materially adversely affected by the Scheme in relation to the handling of complaints.

Conclusion

11.34 I therefore conclude that the Scheme will not create any material adverse impact to the transferring, remaining or existing policyholders' access to adequate complaints handling procedures.

Recognition of the Scheme in other jurisdictions

11.35 I understand from AIUK that all of the transferring policyholders are domiciled in the EEA. Furthermore, the Effective Date of the Scheme is prior to the end of the Brexit transition period. For these reasons, AIUK and AIEU believe that the Scheme, if approved, will be recognised in EEA countries. I agree with this assessment.

Governance and management framework

ACGL's Governance framework

11.36 AIUK and AIEU are fully owned subsidiaries of ACGL. Given that ACGL is the ultimate owner of both of these entities, ACGL's Board of Directors have the authority to provide oversight over both AIUK and AIEU's activities.

AIUK

11.37 AIUK's Solvency and Financial Condition Report dated 20 April 2020 states that its Board of Directors consists of two independent Non-Executive Directors, two other Non-Executive Directors and four Executive Directors.

11.38 AIUK's governance committee structure comprises of the following board sub-committees:

- Risk Committee
- Audit Committee
- Investment Committee
- Remuneration Committee
- Nominations Committee

11.39 In addition, the Risk Committee is supplemented by a sub-committee focused on modelling and capital management. Also, the Audit Committee is supplemented by a sub-committee focused on reserving.

11.40 In addition to the board sub-committees listed above, there exists a Management Committee which reports directly into the Chief Executive Officer. Beneath this Management Committee lies the Underwriting Committee.

11.41 I have reviewed the management and governance framework of AIUK and, in my opinion, it is proportionate to the size and complexity of AIUK's business.

11.42 AIUK have informed me that there will be no change to its governance committee structure or the members of its Board of Directors as a result of the Scheme and therefore I do not expect any material adverse impact to the remaining policyholders as a result of the Scheme in relation to the management and governance framework.

AIEU

11.43 AIEU's Solvency and Financial Condition Report dated 16 April 2020 states that its Board of Directors consists of three independent Non-Executive Directors, four other Non-Executive Directors and one Executive Director, the CEO.

11.44 AIEU's governance committee structure comprises of the following board sub-committees:

- Audit Committee
- Risk Committee

11.45 AIEU has informed me that there will be no change to its governance committee structure or the members of its Board of Directors as a result of the Scheme, with the exception of a new Non-Executive Director replacing a current Non-Executive Director subject to approval from the CBI. I understand from AIEU that this change is not related to the Scheme.

11.46 As I discussed in paragraph 5.40, by the Effective Date most of the business written in AIEU's P&C Division will comprise of business written by the same coverholders which previously wrote similar business in the Transferring Portfolio.

11.47 AIEU has further informed me that, as a result of a services agreement, the same underwriters at AEIS who were previously responsible for underwriting the policies in the Transferring Portfolio will continue to provide the same underwriting services to the AIEU's P&C Division. Additionally, as I described in paragraph 11.17, the same staff at AIEU will continue to support the claims handling of the Transferring Portfolio, with the Chief Underwriting Officer of AIEU's P&C Division providing oversight.

11.48 I have reviewed the management and governance framework of AIEU and, in my opinion, it is proportionate to the size and complexity of AIEU's business and that it will remain appropriate for AIEU's size and complexity following the Scheme.

11.49 Based on AIEU's confirmation that there will be no change to its governance committee structure or the members of its Board of Directors as a result of the Scheme with the exception of the change I described in paragraph 11.45, I do not expect any material adverse impact to the existing policyholders as a result of the Scheme in relation to the management and governance framework.

Transferring Portfolio

11.50 The policyholders within the Transferring Portfolio will move from AIUK's governance and management framework to AIEU's framework as a result of the Scheme. As concluded in paragraph 11.41, I believe AIEU's governance and management framework is appropriate and proportionate to the size and complexity of its business. Furthermore, I understand from AIEU that there will be no change to its governance and management framework following the Scheme and I believe that this framework will remain proportionate to the size and complexity of its business following the Scheme. Therefore, I do not believe the policyholders within the Transferring Portfolio will be materially adversely impacted in relation to the management and governance framework as a result of the Scheme.

Remaining Portfolio

11.51 I understand from AIUK that there will be no change to AIUK's governance and management framework following the Scheme and therefore the policyholders within the Remaining Portfolio will not be materially adversely impacted in relation to the management and governance framework as a result of the Scheme.

Existing Portfolio

11.52 I understand from AIEU that there will be no change to AIEU's governance and management framework following the Scheme and therefore the policyholders within the Remaining Portfolio will not be materially adversely impacted in relation to the management and governance framework as a result of the Scheme.

Conclusion

11.53 Having considered the above, I have not identified any material adverse impact as a result of the Scheme to any of the groups of policyholders in relation to the management and governance framework they are exposed to.

Impact of Brexit

11.54 The UK withdrew its membership from the EU on 31 January 2020 and entered into a transition period during which EU rules and permissions will continue to apply in the UK, however, it is no longer be a member of the EU. The transition period is currently expected to end on 31 December 2020.

11.55 As I discussed in paragraph 11.3, to ensure legal continuity in the UK following its departure from the EU, the UK Parliament approved the transposition of EU laws into UK law. However, over time, the UK government will be able to adapt and remove retained EU laws and regulations that are no longer considered to be relevant or appropriate.

11.56 At the time of this report, the final terms of the UK's relationship with the EU following the end of the transition period have not been agreed. It will take some time for the full implications of UK's departure from the EU to become clear. Nevertheless, it has introduced or exacerbated a number of risks for insurers in the UK that have policyholders based in other EEA countries. Some areas of potential concern are the loss of business passporting rights, exchange rate volatility and a changing regulatory environment.

11.57 Despite these risks to the insurance market as a whole, I do not believe that changes in the insurance market or the UK regulatory environment resulting from Brexit will affect my conclusions contained in this report.

11.58 My reasons for this are:

- The transferring policyholders are transferring to an entity registered, authorised and regulated in Ireland, which will remain in the EU after Brexit. AIEU will be able to provide insurance cover for the transferring policyholders in Ireland and other EEA countries, even if the UK leaves the EU with no deal in place on passporting rights. Uncertainty regarding whether or not their policy provider has business passporting rights will, therefore, be removed for the transferring policyholders as a result of the Scheme.
- Claim payments are mainly settled in Euros for the Transferring Portfolio. Therefore, exchange rate volatility will be reduced for the Transferring Portfolio as a result of the Scheme, as AIEU reports in Euros, whilst AIUK reports in GBP.
- AIEU will continue to be subject to Solvency II, as discussed in paragraph 11.6 so the transferring policyholders will remain subject to Solvency II as they currently are.
- There will be no change to the regulatory jurisdiction of either the remaining policyholders of AIUK or the existing policyholders of AIEU. It follows that the impact of the UK's decision to leave the EU on these groups of policyholders will be the same regardless of whether or not the Scheme proceeds.

11.59 Furthermore, I consider that transferring to AIEU may be advantageous to the policyholders in the Transferring Portfolio. It is not currently clear whether the UK will be able to agree a deal with the EU that will permit UK insurers to provide insurance cover to policyholders domiciled in the EEA following the Brexit Transition Period. Therefore, there is a risk that AIUK will lose its right to provide insurance cover for the policyholders in the Transferring Portfolio. The Scheme eliminates this risk for the transferring policyholders.

11.60 It follows that, I do not expect any group of policyholders to be materially disadvantaged by Brexit as a result of the Scheme.

11.61 I will comment on any further Brexit developments in my Supplementary Report.

Ruling of Mr Justice Snowden on the proposed Part VII transfer of a book of in-payment annuities from The Prudential Assurance Company Limited to Rothesay Life Plc

11.62 On 16 August 2019, Mr Justice Snowden declined to sanction the proposed insurance Part VII transfer of a £12.9 billion book of in-payment annuities from The Prudential Assurance Company Limited ("Prudential") to Rothesay Life Plc ("Rothesay"). I understand that Prudential and Rothesay have appealed this judgement.

11.63 I have considered the extent to which this ruling is relevant to the Scheme.

11.64 While there are clearly some similarities between the two proposals in that they are both Part VII transfers, I believe that there are the following significant differences that could reasonably lead the court to come to a different conclusion:

- The transferring policyholders in the Prudential/ Rothesay transfer were individuals whereas the vast majority of those transferring from AIUK to AIEU under the Scheme are companies.
- Mr Justice Snowden considered that the particular nature of an annuity policy represents an important factor in the exercise of the court's discretion. He noted that the purchase of an annuity was for many people one of the most important decisions that they would ever make, the annuity providing the only, or main, source of regular income for their retirement. Furthermore, once an annuity has been purchased, the policyholder cannot switch providers. The consequence, in his view, was that policyholders will be particularly concerned to select a company with a good reputation and financial standing whom they trust. This is clearly not the same situation for companies buying commercial insurance such as is the significant majority in the Transferring Portfolio where the policyholder can cancel or not renew their policy each year and seek an alternative insurer. Given this, I believe that the policyholders in the Transferring Portfolio are likely to have been less concerned about the reputation, history and financial standing of the insurer at the time they purchased the policy than the Prudential policyholders will have been.
- Mr Justice Snowden took the view that Prudential had a significantly longer and more established reputation than Rothesay. The Scheme is taking place within the same parent group of ACGL and it is therefore more difficult for policyholders to discern a difference of that nature between AIUK and AIEU.
- Various items of Prudential's marketing and policy literature emphasised the financial stability, history and reputation of Prudential and the lifetime nature of the commitment once an annuity was bought from Prudential. When the policies within the Transferring Portfolio were originally purchased, I would not expect it to be on the basis that AIUK or AIEU were promoting the lifelong commitment of their insurance offerings. Furthermore, as the Scheme is between entities within the same parent group of ACGL it is more difficult for policyholders to discern a difference in the financial stability of AIUK and AIEU.
- While the business in the Scheme predominantly consists of long tailed business, on average it is unlikely to be as long tailed as a book of annuities such as those in the Prudential/Rothesay transfer.
- More than a thousand objections were received to the Prudential/Rothesay transfer. In my experience, it is unlikely that a significant number of objections would be received to a transfer of commercial non-life business, such as the Scheme, and it is extremely unlikely that the number of

objections received will be similar in magnitude to the number of objections received to the Prudential/Rothesay transfer. In particular:

- There will be no significant changes to the coverholders used as a result of the Scheme, and therefore from the policyholders' perspective the service is not materially changed
- The Transferring Portfolio is moving within the same ultimate parent group, ACGL and it is therefore more difficult to discern a difference of that nature between AIUK and AIEU.

Non-financial impact of COVID-19

11.65 In Sections 7 and 8, I have discussed the financial impact of COVID-19 on AIUK and AIEU's reserves and capital requirements. I understand from AIUK and AIEU that they have both identified that COVID-19 also introduces a non-financial risk of operational disruption. AIUK and AIEU have been required by UK and Irish government guidance, along with many businesses worldwide, to work remotely, as far as practically possible ("Stay at Home Order"). Both entities have complied with the Stay at Home Order issued by their respect local governments. The UK and Irish Stay at Home Orders were issued within two weeks of each other.

11.66 AIUK and AIEU have informed me that most of their employees have worked remotely continuously since the start of the Stay at Home Order and that their remote working arrangements appear to be resilient. AIUK and AIEU have both informed me that there have been no material delays or failures in their operations since implementing the Stay at Home Order. In particular, AIUK and AIEU have confirmed that there have not been any material adverse impacts on their claims handling or policy administration processes. As a result, there has been no material adverse impact on the service standards received by their respective policyholders.

11.67 In addition, both AIUK and AIEU have informed me that they do not anticipate any adverse effects of the remote working arrangements on their respect business, for example as a result of reputational damage, or on the future provision of services to policyholders or members.

11.68 It is unclear at the time of writing this report how far into the future businesses will be required or will choose to operate remotely due to COVID-19 and whether these requirements will differ between the UK and Ireland. However, for the reasons discussed in paragraphs 11.66 and 11.67, I am comfortable that the transferring policyholders will not experience any increased exposure to the non-financial impacts of COVID-19 as a result of the Scheme, particularly as the same teams of employees will be responsible for providing key services to the transferring policies both before and after the Scheme.

The impact on policyholders should the Scheme not become effective

11.69 I have considered the likely effects on the transferring policyholders should the Scheme not become effective.

11.70 If the Scheme were not to become effective, there would be significant uncertainty regarding the effect of Brexit on the Transferring Portfolio. It is currently unclear whether AIUK will retain its passporting rights when the Transition Period ends. This would mean that AIUK could be in a position where it is no longer authorised to underwrite or service business in other EEA countries via Freedom of Services.

11.71 Consequently, my opinion is that the policyholders within the Transferring Portfolio could potentially be worse off should the Scheme not proceed as a result of the uncertainty of AIUK retaining passporting rights following Brexit.

11.72 If the Scheme were not to become effective, there would be no material adverse impact on the policyholders of the Remaining Portfolio since AIUK’s SCR coverage ratio is improved by the Scheme, as discussed in paragraph 9.48.

11.73 Furthermore, if the Scheme were not to become effective, there would be no material adverse impact on the policyholders of the Existing Portfolio since AIEU’s SCR coverage ratio at the Effective Date remains broadly similar whether or not the Scheme proceeds and the absolute value of Own Funds in excess of the SCR increases slightly. This is discussed in paragraph 9.49.

12 Communication strategy

Policyholder notifications

12.1 The regulations surrounding Part VII transfers require that, unless the Court orders otherwise, all policyholders in all affected companies should be written to in order to inform them of the Scheme. The affected companies may apply for waivers considering, among other things, the likely benefits of contacting the policyholders compared with the practicality and costs of doing so.

12.2 Below I discuss the proposed communication strategy of AIUK and AIEU including the waivers they have informed me that they plan to request at the first Court hearing.

12.3 Prior to requesting the waivers discussed below at the first Court hearing, AIUK has informed me that it will be seeking confirmation from the PRA and FCA that they have no objections to these waivers.

Summary of notifications to policyholders and claimants

Transferring policyholders

12.4 I understand from AIUK that it intends to notify the first named policyholder based on AIUK's policy records or the policy records held by the intermediary that sourced the policy for AIUK (the "Primary Policyholder") for all policies within the Transferring Portfolio that satisfy at least one of the criteria below:

- All open (in-force) policies
- All policies with open claims
- All policies that had not expired prior to AIUK's Extended Notification Period, where the Extended Notification Period is defined as the longer of:
    - the time period following the expiry of a policy by which AIUK estimates that 95% or more of claims will have been notified
    - the time period within which the policyholder is permitted to make a claim where this time period is limited by the local law applicable to the policy concerned.

12.5 The policies in the Transferring Portfolio were mostly written through intermediaries however a small number of these policies were written directly by AIUK. AIUK has informed me that it intends to notify all transferring policyholders which satisfy the criteria in paragraph 12.4, including both those whose policies it wrote directly and those whose policies it wrote through an intermediary.

12.6 AIUK has informed me that intends to notify the transferring policyholders directly and that it has therefore written to the intermediaries to request the contact details for the policyholders that satisfy the criteria in paragraph 12.4 so that AIUK is able to contact the policyholders directly.

12.7 AIUK has informed me that it will be seeking the following waiver from the strict requirement to notify all transferring policyholders:

- To not notify policyholders other than the first named policyholder based on AIUK's policy records or the policy records held by the intermediary that sourced the policy for AIUK
- To exclude policyholders where the policy expired prior to the Extended Notification Period
- To exclude policyholders that AIUK has been unable to reach based on the contact details available to AIUK

12.8 I further discuss AIUK's rationale and my conclusions in respect of these waivers and dispensations in paragraphs12.14 to 12.29.

Remaining AIUK policyholders

12.9 I understand from AIUK that it does not intend to notify any of the policyholders of the Remaining Portfolio and that it is seeking a waiver for this.

12.10 I discuss AIUK's rationale and my conclusions for this waiver in paragraphs 12.37 to 12.39.

Existing AIEU policyholders

12.11 I understand from AIEU that it intends to notify all policyholders within the Existing Portfolio that satisfy the criteria below:

- Primary Policyholders of mortgage policies within AIEU's Mortgage Insurance Division
- Primary Policyholders within AIEU's Alwyn Europe Division. These policies are in respect of motor and pet insurance business
- Primary Policyholders of AIEU's P&C Division.

12.12 AIEU has informed me that it will be seeking the following waiver from the strict requirement to notify all policyholders in the Existing Portfolio:

- To only notify Primary Policyholders
- To exclude policyholders of AIEU's Alwyn Europe Division where the intermediary that wrote the business is unable to notify them or does not notify them.

12.13 I discuss AIEU's rationale and my conclusions in respect of these waivers and dispensations in paragraphs 12.37 to 12.39.

Rationale for seeking waivers

Transferring policyholders

12.14 I understand from AIUK that it is seeking waivers from the requirement to notify all transferring policyholders.

12.15 AIUK is therefore seeking a waiver from the requirement to notify the transferring policyholders other than those discussed in paragraph 12.4. In other words, it is seeking a waiver from the need to notify the following:

- Policyholders other than the first named policyholder based on AIUK's policy records or the policy records held by the intermediary that sourced the policy for AIUK
- Policyholders of policies that expired prior to AIUK's Extended Notification Period
- Policyholders that AIUK is unable to reach based on the contact details available to AIUK.

12.16 I have addressed each waiver in turn below.

Policyholders other than the first named policyholder based on AIUK's policy records or the policy records held by the intermediary that sourced the policy for AIUK

12.17 AIUK intends to seek a waiver to allow it to limit its notifications to the Primary Policyholder of a policy only. The regulations on notifications for Part VII transfers defines policyholders in a very broad sense and may include parties whom AIUK have no knowledge of but which are defined as policyholders under the regulations.

12.18 AIUK has informed me that its computer records do not always identify every policyholder, as defined under the regulations, and therefore may not contain details of such policyholders. In addition, it is possible that there are such policyholders, within the meaning of the regulations, who have become policyholders through a transfer of rights from the original policyholder of which AIUK is not aware.

12.19 AIUK has informed me that, where more than one person is listed as a joint member or policyholder, Communications Pack, as described in paragraph 12.61, will be sent to the Primary Policyholder, being the first policyholder named on the relevant insurance policy as recorded in the computer systems and with whom communications are ordinarily sent in relation to that policy requesting that the Communications Pack is shared with other joint members or policyholders. The cover letter within the Communications Pack will also request that the recipient shares the Communications Pack with all persons who may have an interest in the policy. AIUK has informed me that it will also explain in its cover letter that it will pay the costs of such onward transmission where it is requested to do so.

12.20 It is also worth noting that, as both AIUK and AIEU are members of the Arch Group and the administration of the Transferring Business will, after the Effective Date, continue to be conducted by the same individual AEIS employees from the same locations, albeit on behalf of AIEU rather than AIUK. Where a policyholder or other person with an interest in the policy is not notified of the Scheme as a result of this waiver, but submits a claim after the Effective Date, that claim would still be received by and handled by the same teams, who would handle the claim on the same basis as prior to the Effective Date. As a result, there would be little difference in the claimant's experience.

12.21 I also discuss the advertising strategy in relation to the Scheme in paragraphs 12.53 to 12.59. In particular, AIUK and AIEU intend to advertise a notice of the Scheme in two national newspapers for each of EEA States where AIUK identifies transferring policyholders to be located. The advertising strategy will provide additional publicity concerning the Scheme for policyholders who have not been notified directly.

12.22 I have reviewed AIUK's reasoning and challenged it where necessary and my opinion is that it is proportionate and reasonable for AIUK to seek this waiver given the reasons stated in paragraphs 12.18 to 12.21 above.

Policyholders of policies that expired prior to AIUK's Extended Notification Period

12.23 AIUK has estimated that 95% or more of the future claims that arise on the Transferring Portfolio will be from policies that expired within the Extended Notification Period. I understand from AIUK that there are 70,277 Primary Policyholders within the transferring portfolio with a policy that expired within the Extended Notification Period and that it has received an estimate of £75,000 (excluding Value Added Tax) in relation to the costs for notifying these policyholders.

12.24 AIUK has also estimated that it would need to notify an additional 42,047 Primary Policyholders to capture 98% of the future claims on the Transferring Portfolio. Based on AIUK's estimates and assuming that the cost for each additional Primary Policyholders remains the same, I have calculated that there will be an additional cost of £44,873 (excluding Value Added Tax) from increasing the Extended Notification Period such that an additional 3% of the future claims are from policies that are included in the notifications.

12.25 In order to gain comfort with AIUK's analysis and the conclusions drawn thereof, I have held discussions with the relevant personnel at AIUK to understand the methodology and key assumptions underlying this analysis. I have also reviewed AIUK's analysis in detail for each individual class of transferring policyholders and challenged it where necessary.

12.26 Based on these discussions and my review of the results of AIUK's analysis, I agree that the estimated cost for notifying the policyholders that are not captured within the Extended Notification Period is disproportionate in comparison to the expected number of new claims that will be reported following the Scheme.

12.27 It is also worth noting that, as both AIUK and AIEU are members of the Arch Group and the administration of the Transferring Business will, after the Effective Date, continue to be conducted by the same individual AEIS employees from the same locations, albeit on behalf of AIEU rather than AIUK. Where a policyholder is not notified of the Scheme as a result of this waiver, but submits a claim after the Effective Date, that claim would still be received by and handled by the same teams, who would handle the claim on the same basis as prior to the Effective Date. As a result, there would be little difference in the claimant's experience.

12.28 I also discuss the advertising strategy in relation to the Scheme in paragraphs 12.53 to 12.59. In particular, AIUK and AIEU intend to advertise a notice of the Scheme in two national newspapers for each of EEA States where AIUK identifies transferring policyholders to be located. The advertising strategy will provide additional publicity concerning the Scheme for policyholders who have not been notified directly.

12.29 For the reasons discussed in paragraphs 12.26 to 12.28, I believe that it is reasonable and proportionate for AIUK to seek this waiver.

Transferring policyholders that AIUK fails to contact

12.30 I understand that AIUK is seeking a waiver from notifying policyholders where the attempt to contact the Primary Policyholder from the available contact details has been unsuccessful.

12.31 I understand from AIUK that the contact details for its Primary Policyholders are held electronically and that the contact details are updated at every policy renewal. Contact details are also updated on expired policies where there is an open claim and updated contact details are received. As AIUK has informed me that, as a result, it believes that this waiver will only apply to a small proportion of the transferring policyholders.

12.32 Furthermore, AIUK has informed me that it has appointed a third party agent to cleanse the data to increase the likelihood of postal communications reaching Primary Policyholders, and that it will liaise with coverholders to attempt to locate the appropriate contact details for the Primary Policyholders that AIUK fails to contact.

12.33 AIUK has informed me that, as a result of the reasons set out in paragraphs 12.31 and 12.32, it believes that this waiver will only apply to a small proportion of the transferring policyholders.

12.34 In addition, as AIUK and AIEU are members of the Arch Group and the administration of the Transferring Business will, after the Effective Date, continue to be conducted by the same individual AEIS employees from the same locations, albeit on behalf of AIEU rather than AIUK. In a scenario where AIUK fails to notify a policyholder from the contact details it has available and the policyholder subsequently submits a claim after the Effective Date, there would be little difference in the claimant's experience as the claim would still be received by and handled by the same teams who would have handled the claim prior to the Effective Date.

12.35 I also discuss the advertising strategy in relation to the Scheme in paragraphs 12.53 to 12.59. In particular, AIUK and AIEU intend to advertise a notice of the Scheme in two national newspapers for each of EEA States where AIUK identifies transferring policyholders to be located. The advertising strategy will provide additional publicity concerning the Scheme for policyholders who have not been notified directly.

12.36 For the reasons discussed in paragraphs 12.31 to 12.35, I believe that it is reasonable and proportionate for AIUK to seek this waiver.

Policyholders remaining in AIUK after the Scheme

12.37 I understand from AIUK that it is seeking a waiver from the requirement to notify the policyholders which are not transferring to AIEU.

12.38 AIUK has provided me with the following reasons as to why it is seeking this waiver:

- The Scheme will not affect the level of service received by the policyholders in the Remaining Portfolio as the same claims handling and policy administration teams and personnel will continue to be responsible for managing the Remaining Portfolio following the Scheme. In addition, the Remaining Portfolio is largely managed through intermediaries, and there will be no change to these intermediaries as a result of the Scheme.
- The policyholders in the Remaining Portfolio are not expected to be adversely affected by the Scheme. Conversely, I expect the remaining policyholders to be in a more favourable position from the perspective of security a result of the Scheme. This is because, as I discuss in paragraph 9.5, AIUK's solvency position improves following the Scheme as the value of AIUK's Eligible Own Funds remains the same following the Scheme but there is a decrease in AIUK's insurance liabilities and SCR following the Scheme.
- The Scheme will also be advertised in the London, Edinburgh and Belfast Gazettes and two national newspapers in the UK. I discuss advertising strategy in relation to the Scheme in further detail in paragraphs 12.53 to 12.59.
- Notifying these policyholders would incur disproportionate costs. As discussed in paragraph 12.23, AIUK has told me that it received an estimate of £75,000 (excluding Value Added Tax) in relation to the costs for notifying an expected 70,277 AIUK transferring policyholders. Based on data as at 1 July 2020, AIUK also estimated that there will be approximately 161,000 policyholders in the Remaining Portfolio, some of whom are based in the UK and some elsewhere in the world, although none of the remaining policyholders are based in EEA countries. AIUK expects that the cost per policyholder for notifying the Remaining Portfolio will be similar to that of the Transferring Portfolio. Based on this, AIUK has estimated that the additional cost for notifying the policyholders of the Remaining Portfolio will be in the region of £150,000 (excluding Value Added Tax). I believe that this estimate is reasonable.

12.39 AIUK has provided me with its analysis in relation to this waiver. I have reviewed this and challenged it where necessary and my opinion is that it is proportionate and reasonable for AIUK to seek this waiver given the reasons stated above.

Policyholders existing in AIEU before the Scheme

12.40 I understand from AIEU that it is seeking the following waivers in respect of notifications to the policyholders of the Existing Portfolio:

- Policyholders other than the first named policyholder based on AIUK's policy records or the policy records held by the intermediary that sourced the policy for AIUK
- Policyholders of AIEU's Alwyn Europe Division where the intermediary that wrote the business is unable to notify them or does not notify then

12.41 I have addressed each of these waivers in turn below.

Policyholders other than the first named policyholder based on AIUK's policy records or the policy records held by the intermediary that sourced the policy for AIUK

12.42 AIEU intends to seek a waiver to allow it to limit its notifications to the Primary Policyholder of a policy only. As mentioned in paragraph 12.17, the regulations on notifications for Part VII transfers defines policyholders in a very broad sense and may include parties whom AIEU has no knowledge of but which are defined as policyholders under the regulations.

12.43 This waiver is analogous to the waiver AIUK intends to apply for in respect of Transferring Policyholders which I discussed in paragraphs 12.17 to 12.22.

12.44 AIEU believes that it is appropriate to exclude policyholders other than the Primary Policyholder from its notifications for the following reasons:

- The computer records held by AIEU or the intermediaries through which AIEU sourced the policy do not always identify every policyholder, as defined under the regulations, and therefore may not contain details of such policyholders. In addition, it is possible that there are such policyholders, within the meaning of the regulations, who have become policyholders through a transfer of rights from the original policyholder of which AIEU is not aware.
- AIUK has informed me that, where more than one person is listed as a joint member or policyholder, a Communications Pack, as described in paragraph 12.61, will be sent to the Primary Policyholder, being the first policyholder named on the relevant insurance policy as recorded in the computer systems and with whom communications are ordinarily sent in relation to that policy requesting that the Communications Pack is shared with other joint members or policyholders. The cover letter within the Communications Pack will also request that the recipient shares the Communications Pack with all persons who may have an interest in the policy. AIEU has informed me that it will also explain in its cover letter that it will pay the costs of such onward transmission where it is requested to do so.
- AIEU intends to advertise a notice of the Scheme in two national newspapers for each of EEA States where AIEU identifies transferring policyholders to be located. The advertising strategy will provide additional publicity on the Scheme. I discuss the advertising strategy in relation to the Scheme in further detail in paragraphs 12.53 to 12.59.

12.45 I have reviewed AIEU's reasoning and challenged it where necessary and my opinion is that it is proportionate and reasonable for AIEU to seek this waiver given the reasons stated in paragraph 12.44 above.

Policyholders of AIEU's Alwyn Europe Division where the intermediary that wrote the business is unable to notify them or does not notify them

12.46 AIEU's Alwyn Europe Division comprises of motor insurance business and pet insurance business.

12.47 AIEU has informed me that the motor insurance business is written through four managing general agents ("coverholders") and that its pet insurance business is written through a single coverholder.

12.48 AIEU has informed me that it does not have any direct communications or relationship with the motor insurance and pet insurance policyholders and that the relationship with these policyholders is held either by the coverholders or by the brokers that source the policies for the coverholders.

12.49 AIEU therefore intends to instruct the relevant coverholders and brokers to notify the Primary Policyholders within AIEU's Alwyn Europe Division.

12.50 I understand from AIEU that it is seeking a waiver from notifying policyholders of the Alwyn Europe Division where the coverholder or broker responsible for sourcing the policy is not able to or does not notify the Primary Policyholder.

12.51 AIEU believes that it is appropriate to exclude these policyholders from its notifications for the following reasons:

- AIEU does not have any direct communications or relationship with these policyholders and does not hold the contact details for these policyholders. If the coverholder or broker does not contact any policyholders, AIEU will not have the contact details for these policyholders available and will not easily be able to contact them.
- The Scheme will not affect the level of service received by these policyholders as the same claims handling and policy administration teams and personnel will continue to be responsible for managing the Alwyn Europe Division following the Scheme. In addition, the Alwyn Europe Division is largely managed through intermediaries, and there will be no change to these intermediaries as a result of the Scheme.

- As I concluded in paragraph 9.49, and subject to the capital injection that I discuss in paragraph 8.130 being made, in my opinion the Scheme will not have a material adverse impact on the security of the existing AIEU policyholders.
- AIUK intends to advertise a notice of the Scheme in two national newspapers in each of the EEA States where AIUK identifies transferring policyholders to be located. The advertising strategy will provide additional publicity on the Scheme for policyholders of AIEU's Alwyn Europe Division who are not notified directly. AIEU has also informed me that it intends to enhance the level of advertising in Ireland where the policyholders and intermediaries for its Alwyn Europe Division are mostly located and advertise in three national newspapers, including the Sunday Independent which is one of the highest print circulations in Ireland, the Irish Times and the Irish Broker. I discuss the advertising strategy in relation to the Scheme in further detail in paragraphs 12.53 to 12.59.

12.52 I have reviewed and challenged AIEU's reasons for seeking this waiver, as discussed in paragraph 12.51 and my opinion is that it is proportionate and reasonable for AIEU to seek this waiver given the reasons stated above.

Advertisements

Part VII advertising regulations

12.53 Regulations surrounding Part VII transfers require that a notice stating that an application has been made in connection with the Scheme ("notice of the Scheme") must be published:

a) in the London, Edinburgh and Belfast Gazettes

b) in two national newspapers in the UK

c) where an EEA State other than the UK is the state in which the risk is situated for any direct (as opposed to reinsurance) policy that is being transferred, in each of two national newspapers in that EEA State

d) where, for any inwards reinsurance policy that is being transferred, an EEA State other than the UK is the State in which the establishment of the policyholder to which the policy relates is situated at the date when the contract was entered into, once in one business newspaper which is published or circulated in that EEA State.

Approach to advertising to UK policyholders

12.54 In respect of the requirements stated under paragraph 12.53 a) and b), AIUK and AIEU intend on publishing a notice of the Scheme in:

- the London, Edinburgh and Belfast Gazettes
- the Financial Times (International edition)
- the Daily Telegraph
- the Scotsman

12.55 It is my opinion is that the above advertising strategy is proportionate and reasonable with regards to the Scheme.

Approach to advertising to non-UK EEA policyholders

12.56 In respect of the requirements stated under paragraph 12.53 a) and b), AIEU has informed me that it intends on publishing a notice of the Scheme in the following publications in Ireland:

- the Irish Times
- The Sunday Independent
- The Irish Broker.

12.57 In addition, AIUK and AIEU have informed me that a notice will be published in two national newspapers in each of the other EEA States i.e. Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden.

12.58 AIEU has also informed me that a notice of the Scheme will also be published in the Irish Broker to increase awareness of the Scheme amongst insurance intermediaries in Ireland. AIEU has informed me that the Irish Broker is a widely circulated publication amongst insurance brokers. AIEU sources the motor insurance policies in AIEU's Alwyn Europe Division through brokers.

12.59 AIUK and AIEU have also informed me that a notice of the Scheme will be published in The Financial Times (International edition) to meet requirements stated under paragraph 12.53 d). AIUK and AIEU have informed me that The Financial Times (International edition) is a business newspaper and that it is circulated in all of the EEA States.

12.60 It is in my view that this approach is reasonable and proportionate with regards to the Scheme.

Documentation

12.61 I have reviewed the drafts of the proposed communications materials (the "Communications Pack"). Specifically, I have reviewed the following:

- AIUK's and AIEU's respective draft cover letters to policyholders notifying them that an application has been made in connection with the Scheme
- A sample of AIUK's letter to the intermediaries responsible for placing the policies in the Transferring Portfolio asking whether the intermediary preferred to write to the affected policyholders or whether it preferred AIUK to write to the affected policyholders
- A sample of AIUK's letter to the intermediaries responsible for placing the policies in the Transferring Portfolio requesting the contact details for the policyholders that satisfy the criteria in paragraph 12.4.
- AIEU's letter to intermediaries requesting that intermediaries notify policyholders that an application has been made in connection with the Scheme
- A draft of the "Frequently Asked Questions" supplement that will be provided to affected policyholders

12.62 In my opinion:

- The material is straightforward, provides sufficient information for the policyholders to understand and details any required actions, where relevant
- It explains to the policyholders their right to object and the ways in which they can exercise this right
- The access to the available documentation and relevant information is clear.

12.63 In addition to the communications discussed above, all of the material related to the Scheme will be published on websites hosted by the Arch Group http://www.archcapgroup.com/Insurance/Arch-PartVII. I have seen a draft of the text to be contained on these websites.

12.64 Having reviewed the proposed documentation and the website text, it is my opinion that it is clear, proportionate and reasonable.

Opinion

12.65 Following my analysis of AIUK's and AIEU's policyholder communication and notification strategy as discussed in paragraphs 12.4 to 12.64, I believe that the proposed approach to policyholder and claimant notifications is proportionate and reasonable.

Reinsurer notifications

12.66 Regulations surrounding Part VII transfers require that notifications be sent to every reinsurer whose contracts of reinsurance are to be transferred, in part or in whole, under the Scheme. In addition, it is a requirement to notify person(s) in cases where such a contract has been placed with or through a person authorised to act on behalf of the reinsurer.

12.67 It is proposed that the Transferring Portfolio will continue to benefit from all of its current outwards reinsurance contacts following the Scheme.

12.68 AIUK has informed me that it will notify the reinsurers party to reinsurance contracts which will transfer under the Scheme subject to the following conditions:

- where reinsurance contracts provide cover on transferring gross policies that are within the Extended Notification Period; or
- against whom AIUK has an outstanding reinsurance recovery in respect of the Transferring Portfolio.

12.69 AIUK has informed me that it will be seeking a waiver from contacting reinsurers whose contracts of reinsurance will be transferring under the Scheme but who do not meet the conditions under paragraph 12.68.

12.70 AIUK believes that it is appropriate to exclude these policyholders from its notifications for the following reasons:

- As discussed in paragraph 12.4, AIUK has determined the Extended Notification Period such that 95% or more of claims will have been notified, AIUK believes that as a result of this, there is a low likelihood of reinsurance recoveries arising on the contracts of reinsurance that are transferring under the Scheme but which do not meet the conditions under paragraph 12.68.
- AIUK is notifying all transferring reinsurers with which it has an outstanding reinsurance recovery irrespective of whether the underlying gross policies for the reinsurance contract are within the Extended Notification Period.
- Some of AIUK's reinsurance contracts have been placed with Lloyd's syndicates and other London market insurers, and due to nature of the subscription market, it is possible that:
    - AIUK and its reinsurance brokers' may not have the necessary records to identify every participating reinsurer, in particular, members of the following market
    - There are reinsurers who have become reinsurers through a transfer of rights from the original reinsurer of which AIUK is not aware, for example, through retrocession by the original reinsurer
    - There may be reinsurers that have not notified AIUK, or the relevant reinsurance broker, following a change in contact details.

- AIUK intends to advertise a notice of the Scheme in each of the publications described in paragraphs 12.53 to 12.59. This advertising strategy will provide additional publicity on the Scheme for any reinsurers who are not contacted directly.

12.71 I have reviewed and challenged AIUK's reasons for seeking this waiver and my opinion is that it is proportionate and reasonable for AIUK to seek this waiver given the reasons stated above

12.72 I have also reviewed a copy of AIUK's draft letter to its reinsurers and the brokers responsible for placing reinsurance with AIUK notifying that an application has been made in connection with the Scheme. In my opinion the latter is straightforward, provides sufficient information for reinsurers to understand and details any required actions.

12.73 I believe that AIUK's proposed approach to reinsurer notifications is proportionate and reasonable.

Co-insurer notifications

12.74 AIUK and AIEU have not identified any co-insurers that will be affected by the Scheme and therefore no co-insurers will be included in AIUK's or AIEU's notifications.

12.75 Having discussed AIUK's and AIEU's co-insurance relationships with them and the proposed approach to co-insurer notification and challenged it where necessary, I believe the proposed approach to be proportionate and reasonable.

13 Reliances and limitations

Events following the valuation date

13.1 The conclusions in this report are based on analyses that have been undertaken using data at 31 December 2019.

13.2 AIUK and AIEU have informed me of the following significant developments since 31 December 2019 which I have considered when performing my analysis and reaching my conclusions:

- the impact of the COVID-19 event on both AIUK and AIEU
- the Arch Group's intention to inject an additional £8.9m (€10.5m) in Tier 1 capital to AIEU by 5 December 2020

13.3 I have been informed by AIUK and AIEU that there have been no other developments between 31 December 2019 and the date of this report which would materially impact the analysis I have performed or my conclusions. However, future events could occur between the date of this report and the Effective Date that could change my conclusions.

13.4 I will provide a Supplementary Report prior to the Court hearing at which the sanction of the Scheme is sought to update the Court on whether there have been any material developments since the issue of this report.

Reliance on other parties

13.5 In developing the conclusions in this report, I have relied on the data and accompanying explanations provided to me by and on behalf of AIUK and AIEU. I have not specifically reviewed the data for accuracy and completeness, but I have reviewed it for reasonableness.

13.6 I have carried out investigations, as detailed in this report, to gain comfort on the appropriateness of the methodology and conclusions for the most significant liabilities and capital requirements.

13.7 I have also relied on discussions that I have had with AIUK and AIEU. Where appropriate, I have sought documentation from them to evidence the assertions made to me in those discussions.

Other

13.8 In my judgement, the results and conclusions contained in this report are reasonable given the information made available to me.

13.9 However, there is a limitation upon the accuracy of any estimate of claims reserves in that there is an inherent uncertainty in any estimate of future liabilities. This is due to the fact that the claims will be subject to the outcome of events yet to occur, such as judicial decisions, legislative actions, claim consciousness amongst potential claimants, claims management, claim settlement practices, changes in inflation, and economic decisions. As a result, it should be recognised that future claim emergence will likely deviate, perhaps materially, from any estimate of claims reserves.

13.10 In addition, there is a limitation upon the accuracy of any estimate of capital requirements in that there is an inherent uncertainty in any estimation of future assets and liabilities. It follows that it should be recognised that the actual capital required will likely deviate, perhaps materially, from any estimate of the capital requirements.

13.11 The underlying figures in this report are calculated to many decimal places. Consequently, in the presentation of the figures in the various tables, there may be reconciliation differences due to the effect of rounding.

14 Conclusions

14.1 I have considered the Scheme and its likely effects on the transferring policyholders, the policyholders remaining in AIUK, and the existing AIEU policyholders.

14.2 In reaching the conclusions set out below, I have applied the following principles as set out in relevant professional guidance. I have sought to:

- Exercise my judgement in a reasoned and justifiable manner
- Describe the impact on all classes of beneficiaries (for the purposes of this report, being the transferring policyholders, the policyholders remaining in AIUK and the existing policyholders of AIEU) co-insurers and reinsurers
- Indicate how the Scheme might lead to any changes in the material risks to the benefits of the different classes of beneficiaries
- Assess the impact on all the classes of beneficiaries
- Indicate the proposed rationale for the Scheme to proceed
- Include (in summary) the most material information on which my opinion is based
- Describe the rationale for my opinion.

Transferring policyholders

14.3 I have concluded that there will be no material adverse impact to the service provided to the transferring policyholders and no material adverse impact on the security provided to them, including under insolvency. Therefore, I do not expect that the transferring policyholders would be materially adversely affected by the Scheme.

14.4 Please note this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

Policyholders remaining in AIUK

14.5 I have concluded that there will be no material adverse impact to the service provided to the policyholders remaining in AIUK and no material adverse impact on the security provided to them, including under insolvency. Therefore, I do not consider that the policyholders remaining in AIUK will be materially adversely affected by the Scheme.

Existing policyholders of AIEU

14.6 In addition, I have concluded that there will be no material adverse impact to the service provided to the existing policyholders of AIEU and no material adverse impact on the security provided to them, including under insolvency. Therefore, I do not consider that the existing policyholders of AIEU will be materially adversely affected by the Scheme.

14.7 Please note that this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

Co-insurers of the Transferring Portfolio

14.8 I have concluded that the co-insurers of the Transferring Portfolio will not be materially adversely affected by the Scheme.

Reinsurers of the Transferring Portfolio

14.9 In addition, I have concluded that the reinsurers of the Transferring Portfolio will not be materially adversely affected by the Scheme.

Conclusion

14.10 Given the above, I conclude that the risk of any group of policyholders, co-insurers or reinsurers being materially adversely affected by the Scheme is sufficiently remote that there is no reason why the Scheme should not proceed.

14.11 Please note that this conclusion is subject to the capital injection that I discuss in paragraph 8.142 being made. I will comment on the latest status of the capital injection in my Supplementary Report.

14.12 I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true.

14.13 The opinions that I have expressed and conclusions that I have drawn in this report represent my true and complete professional opinions on the matters to which they refer.

14.14 As required by Part 35 of the Civil Procedure Rules, I hereby confirm that I understand my duty to the Court, I have complied with that duty and I will continue to comply with that duty.

14.15 I do however consider it necessary that I review the most recent information, up to the date of the Court hearing at which the sanction of the Scheme is sought, when this becomes available, before confirming my conclusions and opinions.

Simon Sheaf FIA
Partner and Head of General Insurance Actuarial & Risk
Grant Thornton UK LLP

A Information received

Information provided by or on behalf of AIUK

- ACGL Organisation Chart
- Actuarial Methodologies Document
- Actuarial Reserve Report - Q4 2019
- AICE Own Risk and Solvency Assessment (ORSA) Report - December 2019
- AICE Standard Formula Appropriateness Review dated 29 January 2019
- AIE Performance Summary December 2019
- AIUK - Actuarial Function Report 2019
- AIUK - Part VII Reserves 2019Q4
- AIUK Annual Report and Financial Statements for the year ended 31 December 2019
- AIUK Part VII - Additional data (Other analysis)
- AIUK Quarterly Reporting Templates - year ended 2019
- AIUK Risk Appetite Statement dated March 2020
- AIUK SCR Update - 4 June 2020
- AIUK Standard Formula Calculations (Pre and Post Transfer on a Regulatory and Economic Basis)
- Arch Part VII Transfer Pre Notice to Coverholder - April 2020
- Capital Management Plan dated March 2020
- Capital Management Policy dated March 2020
- Current Reinsurance Programs
- CVs of AIUK Capital Modelling Team
- EU Transfer Files (03.06.2020)
- EU Transfer Policies
- Historical Reinsurance Structure
- LookBack Analysis
- Notification List of Binders
- Part VII AIUK Tax Implications dated February 2020
- Process Charts
- Reserving Policy Document
- Risk Management Policy dated October 2019
- Solvency and Financial Condition Report for the year ended 31 December 2019
- Standard Formula Calculation - 2019 Year End (For Submission)
- Stav Tsielepis' CV
- Steven Loyens' CV
- Technical Provisions Methodology and Process - December 2019

- Thomas Clemmitt's CV

Information provided by or on behalf of AIEU

- AIEU Actuarial Function Report 2019
- AIEU Actuarial Function Report 2019
- AIEU Actuarial Function Terms of Reference December 2019
- AIEU Actuarial Opinion on Technical Provisions 2019
- AIEU Actuarial Report on Technical Provisions 2019
- AIEU Capital Management Plan March 2019
- AIEU Capital Management Policy March 2019
- AIEU Claims Handling Policy May 2020
- AIEU Claims Policy - Alwyn Europe Division
- AIEU Claims Policy - Mortgage and Surety Division
- AIEU Claims Policy - P&C Division
- AIEU Complaints Policy
- AIEU Financial Statements 2019
- AIEU Forecast 2020 Part VII
- AIEU Governance and Risk Management Policy March 2019
- AIEU Investment Guidelines 13 September 2019
- AIEU Investment Portfolio Performance December 2019
- AIEU Investment Risk Policy September 2019
- AIEU List of Outsourcing Agreements
- AIEU Operational Risk Policy March 2019
- AIEU ORSA Report 2019 Update dated July 2020
- AIEU Own Risk and Solvency Assessment (ORSA) Repot December 2019
- AIEU Part VII Pro Forma Analysis 31 December 2020
- AIEU Part VII Pro Forma Analysis as at 31 December 2019
- AIEU Quarterly Reporting Templates 2019
- AIEU Recovery Plan
- AIEU Recovery Policy
- AIEU Reinsurance and Risk Mitigation Risk Policy March 2019
- AIEU Reporting Policy December 2019
- AIEU Risk Appetite Statement September 2019
- AIEU Solvency and Financial Condition Report for the year ended 31 December 2019
- AIEU Strategic Plan 2020

- AIEU Supplemental ORSA Report 2019 dated May 2020
- AIEU Supplemental Strategic Plan 2020 dated May 2020
- AIEU Underwriting and Reserving Risk Policy December 2019
- Annual AIEU Technical Provisions and SCR Validation
- Arch Insurance (EU) dac call with CBI
- Arch Mortgage Insurance dac Own Risk and Solvency Assessment (ORSA) 2017 Report
- Arch Mortgage Insurance dac Standard Formula Review 2017
- Draft AIEU Application for Extension of Authorisation dated 12 February 2020
- Felix McMahon's CV - February 2020
- Gross and Net Lines Reinsurance spreadsheet
- Michael Bennet's CV - February 2020

Information provided by legal advisers

- AIEU Policyholder Notification Letter
- AIUK Notification Framework
- AIUK Policyholder Notification Letter
- AIUK Reinsurance Broker Notification Letter
- AIUK Reinsurer Notification Letter
- Arch Insurance Scheme Document dated 2 July 2020
- Arch Insurance Scheme Summary
- Arch Insurance UK Independent Expert Letter of Approval
- Arch Part VII FAQs
- Arch Part VII Transfer Timetable dated 20 February 2020
- Extended Notification Period Summary
- Initial Letter to Coverholders April 2020
- Instructions to Counsel dated 2 April 2020
- Part VII Website Wording
- Summary of Reinsurance for the Transferring Portfolio
- Witness Statement

Information provided by legal advisers

- AIEU Policyholder Notification Letter
- AIUK Notification Framework
- AIUK Policyholder Notification Letter
- AIUK Reinsurance Broker Notification Letter
- AIUK Reinsurer Notification Letter
- Arch Insurance Scheme Document dated 2 July 2020
- Arch Insurance Scheme Summary
- Arch Insurance UK Independent Expert Letter of Approval
- Arch Part VII FAQs
- Arch Part VII Transfer Timetable dated 20 February 2020
- Extended Notification Period Summary
- Initial Letter to Coverholders April 2020
- Instructions to Counsel dated 2 April 2020
- Part VII Website Wording
- Summary of Reinsurance for the Transferring Portfolio
- Witness Statement

Other

I also relied on information arising from correspondence and discussions with AIUK, AIEU, their legal advisers, and other entities in the corporate group to which AIUK and AIEU belong.

I have checked that all of the above information has been supplied by persons appropriately qualified to provide such information and I am satisfied that it is reasonable for me to rely on this information.

A number of the items received are of a commercially sensitive or confidential nature. All relevant information received has been used to inform the conclusions given in this report, whilst taking care to respect the confidentiality of the entities involved. It should be noted that there are no instances where I have omitted implications of the documentation received from this report for the sake of respecting confidentiality. Therefore, in my opinion it is not necessary to produce a separate document exclusively for the Court providing further details of these data items although these items can be made available to the Court if required.

B Definitions

Annuity	A financial product which pays out a fixed stream of payments to an individual.
Asset	Generally, any item of property whether tangible or intangible, that has financial or monetary value.
Available capital	Total assets less total liabilities.
Available Own Funds	The level of capital available to meet the SCR
Bad debt	A debt that cannot be recovered. Under Solvency II, technical provisions include an allowance for reinsurance bad debt.
Balance Sheet	A statement of the assets, liabilities, and capital of a business or other organisation at a point in time.
Best estimate technical provisions	The technical provisions made up of a claims provision and a premium provision
Booked reserve	The claims reserve shown in the financial statements.
Brexit	The impact of the EU Referendum.
Brexit Transition Period	The current transition period in respect of the UK's withdrawal from the European Union
Capital requirements	The level of funds that an insurance or reinsurance undertaking is required to hold.
Catastrophe	An event that can cause severe damage or suffering. The event could be natural or man-made.
Cedants	An insurance company which passes (or cedes) a risk to a reinsurer.
Chain Ladder Method	An actuarial reserving method used to estimate incurred but not reported claims.
Claims reserve	Funds held for the payment of future claims.
Collateral Accounts	Funds held to cover any claims are collected in advance and held in an account, therefore improving the certainty of the availability of funds to cover claims.
Co-insurer	An insurer that provides coverage to the policyholder in addition to the coverage provided by the primary insurer.
Collateral	Assets provided as security for a future liability.
Corporate Bond	A bond issued by a corporation.
Counterparty default risk	Risk of losses due to default or downgrade of reinsurers or due to non-payment of receivables from third parties
Coverage Ratio	The quantum of assets an insurer has to meet its financial obligations, expressed as a percentage of its capital.
Credit rating	A measure of the financial security of a company provided by a third party agency.

Default	A failure to perform a legal or contractual obligation.
Direct policyholders	Policyholders of an insurance undertaking who are not themselves insurers or reinsurers.
Dividends	A sum of money paid regularly by a company to its shareholders out of its profits.
Effective Date	The date at which the Scheme becomes legally binding. This is expected to be 1 April 2020.
Eligible Own Funds	The portion of own funds that can be used to meet capital requirements after taking account of any restrictions.
Equity	Shares issued by a company
Excess of Loss	This is a type of reinsurance contract whereby cover is provided by the reinsurer above a certain amount, up to a certain limit.
Existing policyholders	The policyholders of the Existing Portfolio
Existing Portfolio	The policyholders within AIUK prior to the Scheme
Expected loss ratio	The ratio of losses to premiums expected at the outset of a year.
Facultative policies	Reinsurance for a single risk or a defined package of risks.
Government Bond	A bond issued by a country's government, promising to repay borrowed money at a fixed rate of interest at a specified time.
Gross	Excluding the effect of reinsurance arrangements. For example, 'gross insurance liabilities' refers to insurance liabilities before taking into account any offsetting reinsurance assets.
Incurred but not reported ("IBNR")	Claims that have occurred prior to a particular date but have not yet been reported to the insurer plus future developments on claims that have already been reported to the insurer.
Independent Expert	The suitably qualified person that produces an independent report on the Scheme, in accordance with FSMA
Internal Model	A bespoke model developed by an insurance or reinsurance undertaking to calculate its Solvency Capital Requirement under Solvency II. All insurers are required to calculate their Solvency Capital Requirement using either an Internal Model or the Standard Formula.
Inwards reinsurance	Reinsurance coverage provided by a reinsurance undertaking to other insurance or reinsurance undertakings.
Large claims	Individual claims with a relatively high value which may be modelled at an individual level for reserving and capital modelling.
Liability	A claim against the assets, or legal obligations of a person or organisation, arising out of past or current transactions or actions.

Liquidity	The degree to which an asset or security can be quickly bought or sold in the market without affecting the asset’s price.
Loss Portfolio Transfer	A reinsurance arrangement in which a reinsurer assumes and accepts an insurer’s existing open and future claim liabilities.
Minimum Capital Requirement (“MCR”)	The lower level of regulatory capital requirement under the Solvency II regime.
Net	Including the effect of reinsurance arrangements. For example, 'net insurance liabilities' refers to insurance liabilities after deducting any offsetting reinsurance assets from the gross insurance liabilities.
Outstanding claims	The estimate of the claims made by the claims handling team of an insurer for claims that have been reported but not yet paid.
Own Funds	The excess of an insurer's admissible assets over its liabilities on a Solvency II basis.
Own Risk and Solvency Assessment (“ORSA”)	The insurance or reinsurance undertaking’s own assessment of the risks to which it is exposed and its solvency, as required under Solvency II.
Parent	An enterprise that controls another (called the subsidiary) through the ownership of greater than 50 percent of its voting stock.
Peer Review	Process by which a piece of work is considered by at least one other individual, having appropriate experience and expertise, for the purpose of providing assurance as to the quality of the work in question.
Premium	The amount charged by an insurer or reinsurer as the price of granting insurance or reinsurance cover, as stated before or after the subtraction of brokerage and other deductions.
Quota share reinsurance	A type of reinsurance whereby risks are shared in pre-determined proportions between the insurer and reinsurer.
Reinsurance	An arrangement with another insurer or reinsurer whereby risks are shared or passed on.
Remaining policyholders	The policyholders of the Remaining Portfolio
Remaining Portfolio	The policyholders that will remain in AIUK following the Scheme
Reserve strength	A measure of the likelihood that the claims reserve will be sufficient to meet future claims
Risk Margin	Under Solvency II, insurers must hold a risk margin in excess of their best estimate of liabilities. This risk margin is designed to represent the amount of capital a third party would require to take on the obligations of a given insurance company. It effectively means that if an insurer were, as a result of a shock, to use up all its free surplus and capital, then it would still have sufficient assets to safely wind-up and transfer its obligations to a third party.

Run-off	A line of insurance business or an insurance undertaking that does not accept new business but continues to provide coverage for claims arising on its policies still in force and that makes payments for claims that have occurred on its policies.
the Scheme	Insurance Business Transfer Scheme of the Transferring Portfolio from AIUK to AIEU
SCR coverage ratio	The quantum of assets an insurer has to meet its regulatory Solvency Capital Requirement, expressed as a percentage of its regulatory Solvency Capital Requirement
Segregated Account	An account held separately from a (re)insurer's other assets, and over which security is provided in favour of the policyholder.
Shareholder	An owner of shares in a company.
Solvency Capital Requirement ("SCR")	The higher level of regulatory capital requirements under the Solvency II regime.
Solvency II	A regulatory regime for insurers which came into force on 1 January 2016 aimed at harmonising regulation relating to risk management and supervision of insurance companies across all EU and EEA countries.
Standard Formula	A standardised calculation for the Solvency Capital Requirement of an insurance or reinsurance undertaking, as prescribed under Solvency II. All insurers are required to calculate their Solvency Capital Requirement using either the Standard Formula or an Internal Model.
Stress and scenario testing	An analysis to test the robustness of a financial quantity by varying a number of underlying assumptions (either one at a time or in various combinations) and observing the resulting change in the quantity of interest.
Subsidiary	An enterprise controlled by another (called the parent) through the ownership of greater than 50 percent of its voting stock.
the Summary Report	A summary of this report to be included in the information sent to the policyholders of AIUK and AIEU
the Supplementary Report	An update to this report covering any relevant matters which have arisen since the date of this report
Technical provisions	The insurance liabilities of an insurer, as determined for regulatory purposes. These are calculated as 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 claims arising on unexpired periods of exposure less any premium in respect of the business written that has not yet been received.

Transferring policyholders	The policyholders of the Transferring Portfolio
Transferring Portfolio	The Transferring Portfolio consists of: • All policies other than inwards reinsurance forming part of the portfolio of general insurance policies of AIUK carried out prior to the Effective Date where the risk associated with such policies is written on a Freedom of Services basis or a Freedom of Establishment basis • The outwards reinsurance policies issued to AIUK where these are relevant to or provide protection for a policy referred to in the previous bullet point • Contracts and other commitments to which AIUK is a party at the transfer date and which relate to the policies or reinsurance policies referred to above (this will include the coverholder arrangements currently in place in the various EEA States other than the UK in which risks are located) • The assets and liabilities (excluding misselling liabilities) relating to each of the above.
Underwrite	This term may refer to (a) the process of evaluating, defining and pricing insurance and reinsurance risks including where appropriate the rejection of such risks; or (b) the acceptance of the obligation to pay or indemnify the insured or reassured under a contract of insurance or reinsurance.
Unearned premium	The premium corresponding to the time period remaining on an insurance policy. Unearned premiums are in respect of the unexpired portion of the insurance and appear as a liability on the insurer's balance sheet.

C Abbreviations

ACGL	Arch Capital Group Ltd.
AEIS	Arch Europe Insurance Services Ltd
AICE	Arch Insurance Company (Europe)
AIEU	Arch Insurance (EU) dac
AIGI	Arch Insurance Group Inc.
AIML	Arch Investment Management Ltd.
AIUK	Arch Insurance (UK) Limited
Brexit	the UK withdrawal from the European Union
CBI	Central Bank of Ireland
CEO	Chief Executive Officer
CPD	The Consumer Protection Directorate
CV	Curriculum Vitae
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ELRs	Expected loss ratios
ENIDs	Events Not in Data
EU	European Union
EWI	Early Warning Indicator
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FSPO	Financial Services and Pensions Ombudsman
GAAP	Generally Accepted Accounting Principles
Grant Thornton	Grant Thornton UK LLP
IBNR	Incurred-but-not-reported
ICF	the Insurance Compensation Fund
IFoA	Institute and Faculty of Actuaries
IQS	Intercompany Quota Share
LACDT	Loss absorbing capacity of deferred taxes
MCR	Minimum Capital Requirement
MGAs	Managing General Agents
MIBI	Motor Insurance Bureau of Ireland
ORSA	Own Risk and Solvency Assessment
PRA	Prudential Regulation Authority
Prudential	The Prudential Assurance Company Limited
Q3	As at 30 September

Q4	As at 31 December
Rothesay	Rothesay Life Plc
SCR	Solvency Capital Requirement
SMEs	Small and Medium Enterprises
SUP18	The guidance set out in Chapter 18 of the Supervision Manual
TASs	Technical Actuarial Standards
the Court	The High Court of England and Wales
the Act	The European Union (Withdrawal) Act 2018
ULAE	Unallocated loss adjustment expenses
UPR	Unearned Premium Reserves
USPs	Undertaking specific parameters

D Checklist against PRA's Statement of Policy and SUP18

The table below cross references the relevant sections of this report to the requirements for the Scheme Report, as set out in the Statement of Policy produced by the PRA in April 2015, namely "The Prudential Regulation Authority's approach to insurance business transfers".

It also cross references the relevant sections of this report to the guidance set out in Chapter 18 of the Supervision Manual ("SUP18") contained in the FCA Handbook of Rules and Guidance to cover scheme reports on the transfer of insurance business. These requirements are identical to those set out in the PRA's Statement of Policy. However, please note that the paragraph references in the table below are to the PRA Statement of Policy rather than to SUP18.

Reference to the PRA's approach to business transfers	Reference to relevant section within this report
2.30 The Scheme report should comply with the applicable rules on expert evidence and contain the following information:	
(1) who appointed the independent expert and who is bearing the costs of that appointment;	Paragraphs 1.3 and 1.5
(2) confirmation that the independent expert has been approved or nominated by the PRA;	Paragraph 1.3
(3) a statement of the independent expert's professional qualifications and (where appropriate) descriptions of the experience that makes them appropriate for the role;	Paragraphs 1.21 to 1.23 and Appendix E
(4) whether the independent expert, or his employer, has, or has had, direct or indirect interest in any of the parties which might be thought to influence his independence and details of any such interest;	Paragraphs 1.25 to 1.27
(5) the scope of the report;	Section 3
(6) the purpose of the Scheme;	Paragraphs 5.48 to 5.50
(7) a summary of the terms of the Scheme in so far as they are relevant to the report;	Paragraphs 5.51 to 5.57
(8) what documents, report and other material information the independent expert has considered in preparing the report and whether any information that they requested has not been provided;	Appendix A and paragraphs 3.15 to 3.17
(9) the extent to which the independent expert has relied on:	
(a) information provided by others; and	Section 13
(b) the judgement of others;	Section 13

(10) the people the independent expert has relied on and why, in their opinion, such reliance is reasonable;	Section 13 and throughout the report.
(11) Their opinion of the likely effects of the Scheme on policyholders (this term is defined to include persons with certain rights and contingent rights under the policies), distinguishing between:	
(a) transferring policyholders;	Section 14 and paragraphs 2.27 and 2.28
(b) policyholders of the transferor whose contracts will not be transferred; and	Section 14 and paragraph 2.29
(c) policyholders of the transferee;	Section 14, paragraphs 2.30 and 2.31
(12) Their opinion on the likely effect of the Scheme on any reinsurer of a transferor, any of whose contracts of reinsurance are to be transferred by the Scheme;	Section 14, paragraphs 2.37 and 2.38
(13) what matters (if any) that the independent expert has not taken into account or evaluated in the report that might, in their opinion, be relevant to policyholders' considerations of the Scheme; and	Paragraphs 3.3 and 3.11
(14) for each opinion that the independent expert expresses in the report, an outline of their reasons.	Throughout the report
2.32 The summary of the terms of the Scheme should include:	
(1) a description of any reinsurance arrangements that it is proposed should pass to the transferee under the Scheme; and	Section 5
(2) a description of any guarantees or additional reinsurance that will cover the transferred business or the business of the transferor that will not be transferred.	There are no guarantees or additional reinsurance that will cover the transferred business.
2.33 The independent expert's opinion of the likely effects of the Scheme on policyholders should:	
(1) include a comparison of the likely effects if the Scheme is or is not implemented;	The likely effects if the Scheme is implemented are discussed throughout the report and summarised in Sections 2 and 14. An assessment of the likely effects should the Scheme not be implemented is discussed in paragraphs 11.69 to 11.73
(2) state whether they considered alternative arrangements and, if so, what;	Paragraph 3.10

(3) where different groups of policyholders are likely to be affected differently by the Scheme, including comments on those differences they consider to be material to the policyholders; and	Sections 7 to 11
(4) include their views on:	
(a) the effect of the Scheme on the security of policyholders' contractual rights, including the likelihood and potential effects of the insolvency of the insurer;	Section 9
(b) the likely effects of the Scheme on matters such as investment management, new business strategy, administration, claims handling, expense levels and valuation bases in relation to how they may affect:	Investment management: paragraphs 10.5 to 10.30 New business strategy: paragraphs 10.59 to 10.62 Claims handling, complaints handling and policy administration: paragraphs 11.13 to 11.34 Expense levels: paragraphs 10.42 to 10.46 Valuation bases: sections 7 and 8
(i) the security of policyholders' contractual rights;	Section 9
(ii) levels of service provided to the policyholders; or	Expense Levels: paragraphs 10.42 to 10.46
(iii) for the long-term insurance business, the reasonable expectations of policyholders; and	Not applicable to the Scheme – the Scheme does not involve long term insurance business
(c) the cost and tax effects of the Scheme, in relation to how they may affect the security of policyholders' contractual rights, or for long-term insurance business, their reasonable expectations.	Cost implications: paragraph 10.42 Tax implications: paragraphs 10.50 to 10.51
2.36 For a scheme involving long-term insurance business, the report should:	
(1) describe the effect of the Scheme on the nature and value of any rights of policyholders to participate in profits:	N/A
(2) if any such rights will be diluted by the Scheme, describe how any compensation offered to policyholders as a group (such as the injection of funds, allocation of shares, or cash payments) compares with the value of that dilution, and whether the extent and method of its proposed division is equitable	N/A

as between different classes and generations of policyholders;	
(3) describe the likely effect of the Scheme on the approach used to determine:	
(a) the amount of any non-guaranteed benefits such as bonuses and surrender values; and	N/A
(b) the levels of any discretionary charges;	N/A
(4) describe what safeguards are provided by the Scheme against a subsequent change of approach to these matters that could act to the detriment of existing policyholders of either firm;	N/A
(5) include the independent expert's overall assessment of the likely effects of the Scheme on the reasonable expectations of long-term insurance business policyholders;	N/A
(6) state whether the independent expert is satisfied that for each firm, the Scheme is equitable to all classes and generations of its policyholders; and	N/A
(7) state whether, in the independent expert's opinion, for each relevant firm the Scheme has sufficient safeguards (such as principles of financial management or certification by a with-profits actuary or actuarial function holders) to ensure that the Scheme operates as presented.	N/A

E My experience

My professional experience is set out below:

- I have worked in or consulted to the general insurance industry for nearly 30 years.
- I am a Partner in Grant Thornton and lead Grant Thornton's provision of actuarial and risk services to the general insurance sector.
- I have fulfilled the role of Independent Expert for several Part VII Transfers and Section 13 Transfers of insurance liabilities, with my other transaction experience including acting as Scheme Actuary for several schemes of arrangements; independent expert assignments; and due diligence for mergers and acquisitions.
- The table below sets out the sanctioned Part VII Transfers and Section 13 Transfers on which I have acted as the Independent Expert or Independent Actuary.

Transfer	Transfer Type	Date sanctioned
Ageas Insurance Limited to Riverstone Insurance (UK) limited	Part VII	March 2020
SCOR UK Company Limited to R&Q Gamma Company Limited	Part VII	March 2020
Aviva Insurance Limited to Aviva Insurance Ireland dac	Part VII	January 2019
CNA Insurance Company Limited to CNA Insurance Company Europe) S.A.	Part VII	December 2018
Zurich Insurance plc to Catalina Insurance Ireland dac	Section 13	October 2018
Zurich Insurance plc to East West Insurance Company Limited	Section 13	March 2018
Congregational & General Insurance plc to International Insurance Company of Hannover SE	Part VII	November 2017
Colbourne Insurance Company Limited to NRG Victory Reinsurance Limited	Part VII	July 2017
Guardian Assurance Limited to R&Q Insurance (Malta) Limited	Part VII	September 2016
Harworth Insurance Company Limited to Royal & Sun Alliance plc	Part VII	August 2014

- I have substantial reserving experience for an extensive variety of classes of business, including personal and commercial lines, and for a very wide range of companies.
- I also have substantial experience of determining and assessing the capital requirements of general insurance companies, including those under Solvency II.
- My other experience in the general insurance sector includes: producing skilled persons reports under s166 of FSMA 2000; Solvency II including all three pillars; design and construction of capital models; IFRS 17; provision of strategic advice; design and implementation of management information systems; rating of portfolios and individual risks; reviews of rating adequacy; development of pricing models; and review and design of reinsurance programmes.

- In 2010, I set up an actuarial team for Quinn Insurance Limited (Under Administration) ("Quinn"). Between 2010 and 2012, I acted as the de facto Chief Actuary and Chief Underwriting Officer for Quinn.

- Prior to joining Grant Thornton in 2006, I was the Chief Actuary for Travelers Insurance Company Limited in the UK and Ireland.

- Before that, I was a senior consultant in the general insurance division of Towers Perrin.

- I am a Fellow of the Institute and Faculty of Actuaries.

- I hold a Chief Actuary (Non-life with Lloyd's) Practising Certificate and a Lloyd's Syndicates Practising Certificate, both issued by the Institute and Faculty of Actuaries. I have previously also held an Irish Signing Actuary Practising Certificate issued by the Society of Actuaries in Ireland, and been recognised as a Responsible Actuary by the financial regulator in Liechtenstein.

- My professional experience includes terms on the Institute and Faculty of Actuaries' Council, Management Board, General Insurance Board, Education Board, General Insurance Reserving Oversight Committee, General Insurance Education and CPD Committee (including a term as chairman), and Education Committee.

F Extract from Engagement Letter

Terms of engagement between Arch Insurance (UK) Limited, Arch Insurance (EU) dac and Grant Thornton UK LLP

Fulfilling the role of Independent Expert on the proposed Part VII transfer from Arch Insurance (UK) Limited to Arch Insurance (EU) dac

1 Introduction

1.1 This letter, together with our standard Terms and Conditions (further details of which are provided below), sets out the basis on which we will provide the services set out below to Arch Insurance (UK) Limited and Arch Insurance (EU) dac (**you** or the **Clients**) solely in connection with fulfilling the role of Independent Expert on the proposed Part VII transfer from Arch Insurance (UK) Limited to Arch Insurance (EU) dac (the **Purpose**).

2 Scope of work

2.1 Our agreed scope of work (the **Services**) is set out below.

2.2 You have asked us to provide an Independent Expert to report on the proposed insurance business transfer scheme to transfer business from Arch Insurance (UK) Limited (“AIUK”) to Arch Insurance (EU) dac (“AIEU”) (the “Scheme”). The Independent Expert’s report will be prepared in accordance with and for the purposes set out in Part VII of the Financial Services and Markets Act 2000 (“FSMA”) and for no other purpose.

2.3 As part of this assignment, the Independent Expert will produce the following reports:

- the main Independent Expert report, prior to the Directions Hearing
- the summary report, prior to the Directions Hearing
- the supplementary report, prior to the Sanctions Hearing.

2.4 The different groups of policyholders affected by the Scheme are expected to be:

- the policyholders transferring from AIUK to AIEU
- the policyholders who will remain with AIUK following the transfer
- the policyholders who are with AIEU prior to the transfer.

2.5 The Independent Expert's analysis and formal reports will follow the relevant FSMA requirements and associated supplemental guidance. His reports will consider the Scheme as a whole and its effect on the policyholders of AIUK and AIEU. In particular, it will include, but not be limited to, an opinion on:

- the terms of the Scheme generally and the effect which the Scheme will have on the (re)insurance policies of AIUK and AIEU.
- the way in which AIUK and AIEU will conduct their (re)insurance business but taking into account the particular circumstances of each of the different groups of policyholders
- the likely scope for deteriorations in each of AIUK’s and AIEU’s claims reserves (i.e. the likelihood and extent to which each of the companies’ reserves may prove inadequate).

- the impact of the Scheme on the security/financial strength afforded to the different groups of policyholders of AIUK and AIEU involved in the Scheme.
- the corporate governance structures operating in AIUK and AIEU and the impact on the different groups of policyholders of AIUK and AIEU involved in the Scheme.
- the impact of the Scheme on the policyholders' access to compensation schemes.
- the impact of the Scheme on the policyholders' access to complaints schemes.
- the impact of the Scheme on the levels of service, including claims handling, provided to the different groups of policyholders of AIUK and AIEU involved in the Scheme.
- the existing and proposed agreements between AIUK and AIEU and their reinsurers.
- guarantees and/or agreements (if any) between AIUK and AIEU.
- guarantees and/or agreements (if any) between each of AIUK and AIEU and their parent company.
- transactions (outside the Scheme) that impact upon one or both of AIUK and AIEU.
- the terms and conditions (if any) expected to be imposed by the Scheme to be presented to the Court.
- the adequacy of any safeguards in the Scheme intended to protect the interests of the affected policyholders
- the fairness of any mechanism implemented at the same time as the Scheme, but not included in the Scheme
- the communications made to policyholders and reinsurers
- the matters required by applicable provisions of the PRA's Policy Statement PS7/15, Chapter 18 of the supervision manual in the FCA's Handbook and the FCA's guidance paper, entitled "The FCA's approach to the review of Part VII insurance business transfers".
- any other matters drawn to my attention by the PRA or FCA or which are required by the PRA or FCA to be addressed within the Independent Expert's reports.

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

2.7 The Independent Expert will not be directly involved in the formulation of the proposed Scheme although he expects to give guidance during the evolution of the detailed proposals on those issues which concern the Independent Expert or which the Independent Expert considers unsatisfactory. The Independent Expert will meet with AIUK and AIEU at an early stage to identify key issues and will support the companies in their liaison with and provision of information to the PRA, FCA and CBI, and share his reports (and drafts of them) with the legal advisers retained by AIUK and AIEU and those employees and directors of AIUK AIEU or their affiliates involved in the Scheme.

2.8 Any changes to the scope of the assignment should be by mutual agreement and confirmed in writing.

3 Data reliance and limitations

3.1 In performing this assignment, the Independent Expert will rely on data and information provided by you, other third party experts such as actuaries and auditors, and industry sources of data. He will not audit or verify this data and information. If the underlying data or information is inaccurate or incomplete, the results of his analyses may likewise be inaccurate or incomplete.

3.2 The Independent Expert's ability to carry out this assignment will depend on a number of key factors:

- that the relevant and appropriate information is readily available
- access to the relevant personnel of AIUK and AIEU for the purposes of interview and discussion
- access to the authors of third party reports for the purposes of interview
- agreement of third parties to his reliance on their reports for the purpose of forming his expert opinion.

4 Duty to the Court

4.1 The Independent Expert's main report and supplementary report will be addressed to the Court and will include, inter alia, the following matters:

- an express statement that the Independent Expert understands his duty to the Court and that he has complied with and will continue to comply with that duty
- a summary of the matters dealt with in the report together with the reasons for those opinions
- a statement setting out the substance of all material facts and instructions that the Independent Expert has received (whether written or oral), which are material to the opinions expressed in his report or upon which those opinions are based
- whether any questions or issues specifically fall outside his expertise, and how he has dealt with those questions or issues
- any other matters required under FSMA, the PRA’s Policy Statement PS7/15, Chapter 18 of the Supervision Manual ("SUP18") contained in the FCA Handbook of Rules and Guidance to cover scheme reports on the transfer of insurance business, or the FCA’s guidance paper, entitled “The FCA’s approach to the review of Part VII insurance business transfers”.

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