

IN THE MATTER OF THE EQUITABLE LIFE ASSURANCE SOCIETY ETC

Submissions relating to the Matching Adjustment only

Day 1 (22 November 2019)

MR MOORE: My Lord, the proper approach to a systemic matter like that [i.e. matching adjustment] is to deal with it, as one would with any issue relating to these rules and whether they should be changed, by consultation and engagement with all the appropriate stakeholders in a far more broad-ranging and wide-ranging way than is possible under a Part VII . So, in my submission, my Lord is exercising his discretion in the context of the regulatory regime as it is, and it's no part of your Lordship's function to say, "Well, I think that's a rotten regime". That is the regime that we have. That must be the context in which the exercise of your discretion was intended to be exercised.

Day 2 (25 November 2019)

MR WEITZMAN: In the circumstances, I will try to be brief now, but may I ask your permission to say something further once Dr Buckner has had his say.

First, from the perspective of the PRA, the key point in relation to matching adjustments is that they form part of the regulatory regime and, in particular, Solvency II. As your Lordship is aware, Solvency II is a largely maximum harmonising directive which is required to be incorporated and which has been incorporated into UK law. The PRA, as Prudential regulator, is obviously required to give effect to that regime and to approve firms' use of matching adjustments where the eligibility conditions for such use set out in the relevant regulations are satisfied and to assess firms' financial resources taking account of any permitted matching adjustment. To put it colloquially, the PRA cannot ignore its own rules.

Second, and for the avoidance of doubt, I should also make clear that the PRA supports the principles underlying matching adjustments. That is on the basis that, properly implemented, and I emphasise properly implemented, matching adjustment more appropriately reflects the risks to which firms are exposed. It enables firms to look through short-term volatility in the market and avoid financial stability risks arising out of such movement and consequent forced selling of assets. Your Lordship has been referred in this respect to the speech of David Rule, the Bank of England's executive director of insurance supervision, a copy of which is annexed to the PRA's second report at page 27 onwards, with the relevant passages being, in particular, at page 31 onwards. Your Lordship, unless you wish me to do so, I wouldn't read that out to your Lordship.

MR JUSTICE ZACAROLI: No. Thank you.

MR WEITZMAN: Your Lordship, I have referred to the PRA supporting matching adjustments if properly implemented. In this respect, I should emphasise that firms' use of matching adjustments is subject to strict eligibility criteria as set out in Solvency II and implemented by the Solvency II regulations referred to as the HMT regulations in our second report. Importantly, those criteria relate to both the liabilities in question and the assets in question. As I say, the PRA's view is that where those criteria are met, the use of matching adjustments by a firm appropriately reflects the risks to which that firm is exposed in its regulatory balance sheet. Turning to Dr Buckner's objections to the use of matching adjustment, the PRA's position is that these are not matters which are suitable for debate or determination as part of this hearing. There are two main reasons for this.

First, Dr Buckner is in effect asking the court to find that the applicable regulatory regime, as set out in Solvency II and as given effect to by the HMT regulations, is wrong. I would respectfully submit that that is not something this court should do. The regulatory regime is the product of consultation with interested parties and careful consideration of the issues arising by the relevant regulatory entities. As I have said, it has been given statutory effect in this country.

Against that background, I would respectfully submit that it is not for this court to second-guess the process I have described or to substitute its judgment for the judgment of those responsible for the development of Solvency II and the relevant regulations. For the avoidance of doubt, I make clear that I am not suggesting that the current regulatory regime in relation to matching adjustments can never be challenged or changed. What I am saying is that any such challenge needs to be made not in this

court but by submission to the relevant bodies responsible for that regime and that such change can only be made after appropriate consultation with interested parties and by amendment of the relevant statutory provisions.

Secondly, the issues which Dr Buckner raises relate to quite complex matters of economic and actuarial theory and/or science, depending on how you regard economics and actuary. As such, they are simply not matters which are suitable for determination by a court. This is because courts don't have the necessary expertise to determine what is the correct applicable economic and actuarial theory as a matter of general principle. It is not the court's role, I would respectfully submit, to do so.

Thus, the way I would put it is this: even if this court had before it evidence from experts in the field, which it does not, and those experts' evidence had been tested in cross-examination, which it has not, the court would still not be in a position to determine whether, as a matter of principle, matching adjustments should or should not be allowed. Instead, and at most, the court could say, in relation to a particular case, whether the use of matching adjustments fell within or without the bounds of reasonableness. Turning to the present case, if I may.

MR JUSTICE ZACAROLI: Do you say it is beyond the capability of the court to determine whether the use of matching adjustments in a particular case renders the particular company more at risk of insolvency than the transferring company?

MR WEITZMAN: I can't go that far, your Lordship, self-evidently.

MR JUSTICE ZACAROLI: No.

MR WEITZMAN: But I can say that that is a decision the court can only make on the basis of proper expert evidence, explored in cross-examination and that, even in those circumstances, any decision by the court is likely to be very hedged about because one is essentially attempting to assess *future possibilities* in respect of a company which will have a large number of relevant matters going to its financial soundness, many of which, like matching adjustments, are based on matters of *economic theory prediction, for example, the liabilities, how one assesses them, etc.* Matching adjustments [*sic*], if I can put it like this, *is simply one of a parcel of adjustments/assumptions that are made in arriving at a figure for a firm's solvency capital requirement.* In truth, if one wanted to go down that path, one would need to look at every element of the *solvency capital requirement.*

DR BUCKNER: My Lord, thank you. I had five points I was going to raise. I now have six. I think the first of those should be my standing in this, because it has been raised that I am a non-profit policyholder, not a with-profit [policyholder], and it's perfectly correct to say the non-profit side of it is a relatively small part of ELAS's balance sheet. I think it is 177 million. Can anyone correct me on that?

MR JUSTICE ZACAROLI: The precise number doesn't matter –

DR BUCKNER: The precise number doesn't matter. That's fine. That is correct. Let's take Mr Weitzman's last objection first, which is: well, we have talked a lot about matching adjustment and how it is very, very, very important that the court doesn't sort of consider matching adjustments but, at the same time, by the way, it doesn't really matter here because it is all too small. I think my point would be the current arrangement or the current proposed arrangement is that there's a reinsurance agreement in place and there's a pass-through – I think Mr Moore said that on Friday, there's a pass-through or cut-through – which means that any claims that creditors would have on the whole balance sheet of ULP in the future would not affect the reinsurance agreement because it is passing through. That is my understanding.

MR JUSTICE ZACAROLI: That's my understanding too.

Dr BUCKNER: And that is the court's understanding.

[MR JUSTICE ZACAROLI] Correct.

[Dr BUCKNER:] On the other hand, and this goes right back to my initial conversations with Mark Utting at ULP, ... [he] said, "Don't worry, there's a reinsurance agreement in place. That's an asset that will be held by ULP. You're okay. That will never go away"; and I said, "Okay, but if it never goes away, then why not give me a guarantee it will never go away?" [They said] "Oh, it's absolutely impossible, it can never happen", but they have refused to date to give that guarantee.

So I think, regarding my standing, my point still stands. I have a concern about MA. The balance sheet to which – the portion of the balance sheet to which MA applies is small, but then my policy is small as well. My policy is a more significant proportion of that small part of the balance sheet than it is with the total balance sheet. So that was the first point, which I've now raised. The other five points may take some time and my question of the court is, how long do I have? I think it will take me up to an hour.

MR JUSTICE ZACAROLI: Well, let's see where we go. There's been a lot of discussion of it. I have read what you have put in –

DR BUCKNER: Yes.

MR JUSTICE ZACAROLI: – in relation to it so you don't need to read out everything you have put in already.

DR BUCKNER: I shan't read out anything. I've actually prepared a new – perhaps I can hand this over. Freshfields should have a copy of this. (Handed) The point I was going to raise – the five points I was going to raise –

MR JUSTICE ZACAROLI: Do you want to list them first? Perhaps you are about to do so. That makes it easier for me to follow.

DR BUCKNER: I was about to do so. Let me just go through the five points I was going to raise. One is confidentiality. That should not take long. We discussed on Friday playing it by ear, as it were. I do not propose to play anything by ear. I will simply give the facts as they stand. All public domain information. The court may draw any inference it likes from that but I will not giving any information that's remotely confidential.

MR JUSTICE ZACAROLI: Right. Thank you for that.

DR BUCKNER: The second point is what I call the state of Denmark. Mr Moore, on Friday, he didn't use the words "state of Denmark", but he said, "Oh, well, if there is something rotten, as it were" – he did use the word "rotten" – If there's something rotten, it is not for this court to make a judgment on that, and that was re-affirmed ". Well, that point was re-affirmed in the PRA submission itself, their second submission, and it was reaffirmed just now by Mr Weitzman, who said – used the words, "Matching adjustment is not a matter for this court ". He said that twice and he said it's a matter for appropriate consultation. So I call that the state of Denmark question – which is a concern for me.

My third point will be the something-for-nothing point, which was the colloquial expression used on Friday, which then segues into the liquidity versus default risk. I think it's a key point of the PRA ... and of the applicant's submission. It is a key point that, taking aside short-term volatility of your asset markets, that [volatility] will sort of disappear, so if you hold your assets to maturity, there is absolutely no risk of this being subject to short-term volatility.

However, as we all know, there is default risk. The asset you hold might not mature. It might have defaulted. So there's a whole question of how you divide the spread into liquidity versus default risk. That segues into the matter which is deemed to be complex, too complex for this court. What I have is – I hope the presentation will make these complex economic matters clear to the court. And, actually, they're not complex. Financial economics is mostly about detail which is complex, but the basic principles are not. I hope to communicate those. That third point I think will take some time.

The fourth point is that about the independence of the independent expert – which we could drop. I think it is an important one.

The fifth point is the ULP actual solvency position. It was claimed on Friday, and in the submissions, that my number of 28% capital coverage ratio is wrong and that it is actually 64%. We might want to address that, if there is time. People are saying that I'm giving the wrong number. I don't think I am. So those are the five points. For the submissions concerned, there is submission 1, which I said on 1 November, which should be in – excuse me, my eyesight is not that good. That's better. That should be in volume E, part 1, tab 8. We have already discussed many of the issues in that, but there is a bit at the end where I quote various experts which –

MR JUSTICE ZACAROLI: Which document are you referring to?

DR BUCKNER: My first submission, made on 1 November, and it should be in volume E, part 1, tab 8.

MR GIBBONS: Core bundle 3, behind tab 13.

DR BUCKNER: Oh, is it.

MR JUSTICE ZACAROLI: I have the bundle. I am just trying to find the right page.

DR BUCKNER: That's what I called my submission 2. The problem is it's all sort of bundled together, [in] a whole load of emails.

MR JUSTICE ZACAROLI: Yes, I have it, the 1 November one.

DR BUCKNER: 1 November, you have that, and then there's one sent on I think the 14th. Let me have a look. (Pause) There's one dated 20 November, I'm calling that submission 2. That should be in that same bundle, volume 3, tab 13.

MR GIBBONS: Page 53 of the core bundle.

DR BUCKNER: Yes, thank you. I've just handed you –

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: Fine. So those are the three documents. Right. Shall I go into the five points now?

MR JUSTICE ZACAROLI: Yes, please do.

(1) DR BUCKNER: Point 1: confidentiality. Yes, I don't want to play this by ear. You know, I had several sort of warnings, let's call them. It is very easy for a warning to come across as a threat but I don't propose to raise any issues of confidentiality. There are, by the way, two issues here. One is FSMA confidentiality, which is a criminal offence, and is absolute. It is absolute. If you breach that, then you've committed a serious offence.

Then there is stuff that's related to my contract of employment and I discussed this with the bank the week before last and they said basically any information I volunteer to the court is covered under my contract of employment. So I can't volunteer any information to the court. However, they are satisfied that if the court asks for anything, so long as it doesn't violate FSMA 348, then it's fine for me to answer. That's my understanding. If the PRA wants to comment on that, it can. However, I am going to present the facts in the way that, you know, will probably make the situation plain.

I think the key thing is, obviously, I can't reveal the nature of what is confidential without breaching confidentiality itself, but I think the question is: how did the PRA come up with the solvency things it did, given that – and how is it that the PRA supports the principle of matching adjustment when, if you look at my first submission at the end, the 1 November one, there's a whole bunch of experts, three of whom were employed – no, are employed – by the Bank of England. How is it that they're saying, you know, in effect it's a load of nonsense? Let me read one of them out.

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: David Miles' – he's actually quoted from an interview. There was an earlier objection by Freshfields in a letter of 14 November that I took these quotes out of context. Well, I didn't. For example, David Miles, he's a professor at University College and he was a member of the Monetary Policy Committee at the bank, who I know quite well. He – the quotation is taken from an article which is about matching adjustment – the whole article is about, you know, is it a good thing or bad thing. It's a totally neutral article but it quotes various people, and he says: "If a liability is issued on the expectation of a promise that is risk free (ie a pension) or close to risk free, then it must be discounted at the risk-free rate otherwise we descend into nonsense (note the word 'nonsense')".

"Suppose we raise 1 billion from policyholders with the expectation that their exposure is absolutely safe [that's the policyholders' expectation] and we back this liability with £1 billion of assets with a promise of a higher than risk-free return, are we to discount liabilities so that their present value is £800 million or even £600 million? Can we make £200 million or £400 million out of nothing? That's a nonsense and a dangerous road to go down."

So we're touching on the something-for-nothing point, which I'm going to discuss in a minute. But going back to confidentiality, there is a question underlying here. You have to say: well, why is it that – Martin Taylor is another, he's still with the bank, and Don Kohn, who I think is on the Financial Stability Committee, has made [a] similar statement. These are all [talking about] about the principle of whether it is right to discount risk-free liabilities by a risky asset and they are saying, no, you shouldn't, you should always discount by the risk-free rate or close to risk-free rate, as in the case of the gilt. So I think that's the question. I am not going to say any more about that but the court has to ask itself: why are we in this position of a lot of experts and all the financial theory saying one thing, and the PRA apparently saying – or parts of the Bank of England saying something else? That's all for the confidentiality point.

(2) The state of Denmark point. Okay, so the Freshfields' letter of the 14th said something like, "Oh, well, this is a matter for policyholders to take up with the PRA", and Mr Weitzman just now said a whole bunch of stuff about: well, nothing to do with the court, it's a complex matter, you know, if people have any worries, then policyholders, you know, take it up with the appropriate authorities and not with the court. This is not for the court to decide.

I really disagree with that and my analogy is this: there are some people living in a building with perfectly adequate fire cladding and the proposal is to move them to a building which has a fire certificate issued by the relevant – the appropriate authority, the fire department, but there's been a lot of press reports, and a lot of experts who are outside the fire department are saying, "Well, this is cladding is unsafe. It's a fire risk". Now there's a court hearing to decide whether the residents should be moved and the judge has to make the decision. Should the judge say: well, you know ... this is not a matter suitable for debate". I think I'm quoting [Weitzman] there. This is not a matter suitable for debate as to whether the fire department has, you know, gone about the whole thing in an appropriate way and it's an authority. If residents are worried about the cladding being unsafe, they should take it up – they should take it up with the fire department, not the with court. Okay. But then I say: okay, well, this matter actually has already been taken up with the PRA, if you followed the recent debate on the Rothesay/Pru [matter].

There ... was a letter that I and Prudential policyholders and a bunch of experts sent to the PRA, saying precisely what I am raising here: matching adjustment is a problem. It's not recognised by any independent – truly independent experts. We have a polite letter from the PRA saying – from Sam Woods, saying, "Well, not really a matter – nothing we can comment on". So this is rather like writing to the fire department and saying, "We are worried about the cladding, we think it is really dangerous, can you reassure us", and the ... head of the fire department writes back and says, "Well, you know, can't really comment on fire safety". That's an important issue.

And why should the PRA comment? The P stands for Prudential. It is the Prudential Regulation Authority and it looks after Prudential matters, which is the safety of firms. I can see that Solvency II, I think it's articles 26 and 27, says: well, PRA must have regard – the relevant authority must have regard to financial stability and it must have regard to policyholder safety. So you have these two potentially conflicting objectives. But, to me, it's like a fire department that issues the fire safety certificate, also answerable for the financial condition of the firms that made the cladding.

There is an inherent conflict in a regulator whose primary job – and he [Wood] is part of an institution, the Bank of England, whose primary job is to protect financial stability, deciding on matters which, for this court, policyholders depend on. So my entire point here is that if policyholders can't depend on this court, then it has no one to depend on. The only other way these issues typically resolve is when a firm blows up, goes insolvent, and then there's a Parliamentary inquiry and the usual things happen.

MR JUSTICE ZACAROLI: Can I just understand the relevance of your objections to matching adjustment in the context of this case.

DR BUCKNER: Of this application, yes.

MR JUSTICE ZACAROLI: There are two possibilities here. One is you are concerned about the relative strength of Equitable Life and Utmost.

DR BUCKNER: Correct.

MR JUSTICE ZACAROLI: That's one possibility. So you say that the solvency risk in relation to Utmost is larger than the insolvency risk in relation to Equitable, therefore the transfer should not take place. That is one point.

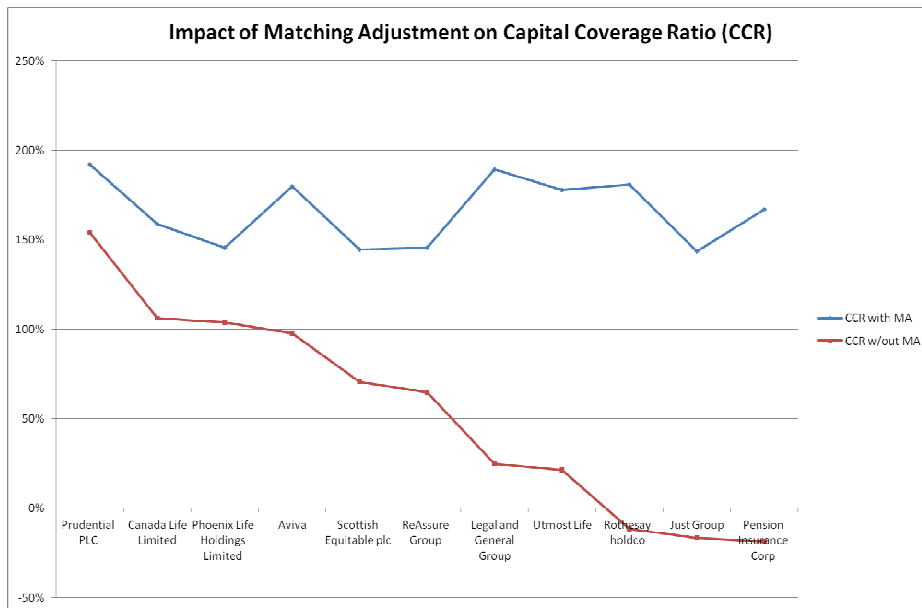
DR BUCKNER: That is my – yes.

MR JUSTICE ZACAROLI: The second point, and I will just see whether you are running both points, is that, forgetting the relativity, there is such a significant solvency risk in relation to Utmost that the transfer should be refused for that reason; not merely because it is relatively worse, but because it is absolutely in such a serious solvency condition that it would be wrong to sanction the transfer. Do you run both points, or is the relativity –

DR BUCKNER: I would go with both points. My point 5 was going to be on the actual solvency position of ULP. Actually, something I omitted, there is already some tier 2 debt issued by the parent company to ULP. Remember, tier 2 debt counts as solvency capital for Solvency II purposes but not for statutory purposes. So, yes, the second – yes, the relative point holds. I think if all firms were equally insolvent, as it were, because of matching adjustment, if the entire industry were on exactly an equal footing, then I think that point about, you know, the court is concerned with specific issues, not general ones [is valid].

So if all buildings equally everywhere have cladding that's unsafe, there's no reason for a court to decide on whether – it's not a matter for the court to decide whether - residents should move from building A to building B.

On the other hand, if the residents are being asked to move from a building that is kind of safe, where the cladding is kind of safe, maybe not totally safe, to a building where the cladding is manifestly unsafe, then that comes to point 2, your point 2, then I think there's an issue for the court. So that's all I have to say on the state of Denmark question, as I call it; is there something rotten in the state of Denmark. Actually, no, there is one more thing. My submission 2, which is the 20 November one, there's a chart right at the end. In appendix B, the capital coverage ratios.



MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: There's a blue line and a red line.

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: I think that illustrates my point about the relative – well, it illustrates both points about relative and absolute. You can clearly see that the blue line is the capital coverage ratio with matching adjustment, and you can see that for all the firms in that sample – this is all public, nothing confidential, all public domain, and taking the relevant firms' SFCRs. You see the blue line sort of hovers around nicely at around 150% and above.

And, by the way, and I'm going to talk about this in a second, that 150% – no, actually, the ratio quoted by ULP, yes, 178%. So ULP, Utmost Life, yes, it's about 178%. That corresponds to a risk of default of one in half a million years, which is great. You could not get safer than that. I think humans started evolving half a million years ago. So, you know, an early evolving human could have taken out a policy with Utmost and would only have lost all their money just once in all the intervening time, half a million years. So that's the blue line. It makes it look as though, if you ignore the red line, it makes it look as though all the firms are ... reasonably well capitalised and they're all sort of in roughly in the same position. It's all good.

But then look at the red line, which is simply a simple calculation – you strip out the matching adjustment benefit and then it's a really different picture. You see Prudential and Canada Life, Phoenix, sort of seem reasonably good, but not as good as the blue line. So the fire cladding is sort of not perfect but reasonably safe. As you go down towards the right, you see it gets sort of worse and worse. Legal & General, quite thinly capitalised in my view. (Again, public domain data).

Going to Utmost, I have given a figure of 21% there, not my 28%. The reason I give 21% is I should have, in my original submission, divided by the capital requirement once matching adjustment is taken away. So 28% is with the original capital requirements; 21% is with the new capital requirement after you have subtracted MA, because capital requirements tend to go up when you take MA away. So I'm saying I think 21% is the right number and not 64%, which was claimed earlier. Then you see – I call them the three bears: Rothesay, Just Group and Pension Insurers Corp which are actually – they're negatively capitalised once you remove the matching adjustment benefit. Okay. So coming to ... my third point, looking at the time. Is it 25 to or 5 to?

MR JUSTICE ZACAROLI: It is 25 to. We'll take a break in ten minutes.

DR BUCKNER: Sorry?

MR JUSTICE ZACAROLI: We'll take a 5-minute break in 10 minutes' time.

DR BUCKNER: Okay, a 5-minute break. The something-for-nothing point, which will segue into the default risk versus liquidity premium. If we turn to my submission 3, the final one, which I've just given you –

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: – there are two figures there. There's table D2.3.

MR JUSTICE ZACAROLI: Where is that?

DR BUCKNER: It is – if you take – there's – I've labelled – "MA benefit" is the first point. Turn over and we get to something – it should be on the third page –

MR JUSTICE ZACAROLI: I see, on the bottom of the page, yes.

DR BUCKNER: It's the bottom of the page, yes, sorry. That's the matching adjustment for ULP from their 2018 report.

of the two MA portfolios.

Matching Adjustment Rates			
Component	Description	Value at 31/12/18	
		NPF MA1	NPF MA2
Rate 1	Single annual discount rate that equates the discounted value of the expected liability cash flows to the market value of the assets held to match those cash flows	3.06%	1.38%
Rate 2	Single annual discount rate that equates the discounted value of the expected liability cash flows to the best-estimate liability calculated using the basic risk-free interest rate term structure with no adjustments	1.38%	1.38%
Fundamental Spread	A component of credit spreads that reflects the cost of downgrades and a long-term average spread underpin - it varies by: currency, asset class, credit rating, and duration	0.38%	0.00%
Matching Adjustment		1.30%	0.00%

Just adding those numbers up, it's fairly simple. If you add the matching adjustment to the fundamental spread, which is the bit that Mr Moore referred to on Friday as being the spread attributable to default risk, you see it is 130 basis points for MA, 38 basis points for FS, fundamental spread, which adds up to 168 total spread above risk free.

What they call rate 2 is the actual – it looks like the risk-free rate or, rather, is the EIOPA risk-free rate, which confusingly is not the same as the actual risk-free rate. 306 basis points is the total spread and if you add those numbers up it all – so if you add the bottom three numbers up, they should equal the top number. In fact, they do equal the top number. So we have matching adjustment of 130 basis points.

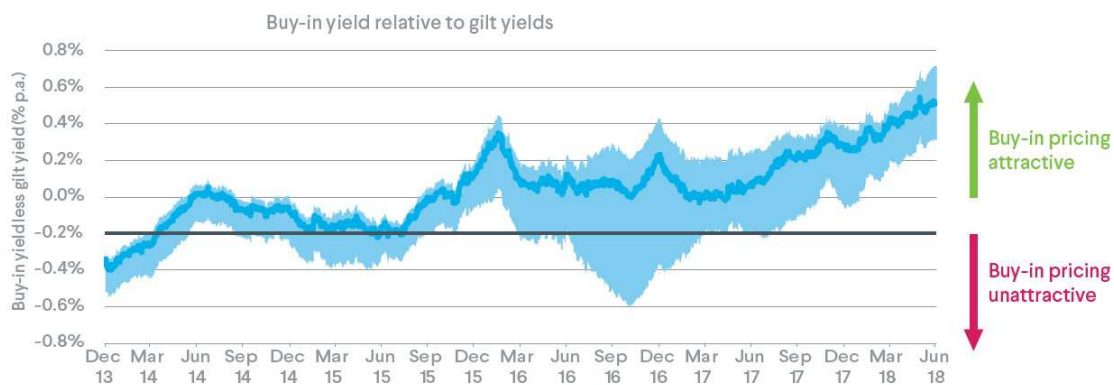
(3.1) I now want to turn to the point about the something for nothing. If you look at top of the page ... it looks about half a billion pounds of corporate bonds held by Utmot, I think supporting policies like mine, or some policies like mine.

'Long term Creditors' (subordinated loan) are set out in Sections D.3 and E.1.1 respectively.

Assets and liabilities other than technical provisions (£ millions)	UK GAAP Statutory Accounts	Reclassifications	Accounting Policy differences	Solvency II value
Assets held for index-linked and unit-linked contracts	621.8	0.0	0.0	621.8
Corporate Bonds	504.1	8.5	0.0	512.6
Government Bonds	322.8	2.4	0.0	325.2
Collective Investments Undertakings	95.7	0.0	0.0	95.7
Equities	4.5	0.0	0.0	4.5
Derivatives	14.4	0.0	0.0	14.4
Deposits other than cash equivalents	3.7	0.0	0.0	3.7
Cash and cash equivalents	78.3	0.0	0.0	78.3
Intangible assets	24.8	0.0	(24.8)	0.0
Property, plant & equipment Including for own use	3.5	0.0	0.0	3.5
Prepayments and accrued income	11.5	(11.5)	0.0	0.0
Reinsurance recoverables*	5.1	0.0	(20.4)	(15.3)
Reinsurance receivables	0.5	0.0	0.0	0.5
Receivables (trade, not insurance)	5.4	0.6	0.0	6.0
Loans on policies	0.7	0.0	0.0	0.7
Deferred tax asset	0.6	0.0	0.0	0.6
Insurance and intermediaries receivables	0.2	0.0	0.0	0.2
Total assets	1,697.5	0.0	(45.2)	1,652.3
Outstanding claims	(9.3)	9.3	0.0	0.0
Payables (trade, not insurance)	(6.7)	(2.7)	0.0	(9.5)
Deposits from reinsurers	(6.2)	0.0	0.0	(6.2)
Pension benefit obligations	(6.0)	0.0	0.0	(6.0)
Accruals and deferred income	(2.7)	2.7	0.0	0.0
Reinsurance payables	(0.4)	0.0	0.0	(0.4)
Provisions other than technical provisions	(0.3)	0.3	0.0	0.0
Insurance and intermediaries payable	(0.2)	(9.3)	0.0	(9.4)
Deferred tax liabilities	0.0	(0.3)	(9.2)	(9.5)
Total current liabilities, other than technical provisions	(31.9)	0.0	(9.2)	(41.0)
Long term creditors (Subordinated loan treated as Tier 2 Capital for SII purposes)	(35.0)	0.0	35.0	0.0
Assets less liabilities, excluding technical provisions	1,630.6	0.0	(19.4)	1,611.3

Let's call that asset A. So any insurance company has an asset and a corresponding liability to pensioners and one asset will match and support the other. So you have A, the asset held by the insurance company, you have B the liability that it's supporting, and C, you have the same liability that [is] viewed from the pensions point of view, which is also an asset. So you really have two assets, A and C. A is the asset held by the insurance company. C is the asset held by the pensioners which corresponds to asset A. Now, the argument is made that the matching adjustment, in this case 130 basis points of ULP (and it can get higher for other firms) the case has been made that that's all down to liquidity. So there's a default risk, which is 38 basis points, which is a fraction of – it's about a quarter of the whole spread.

The case is made that that's all down to liquidity, that if you hold a pension for a long time, a pension asset is very, very long-term, so there must be a liquidity premium attached to that. Okay. Well, now let's turn the page and look at the chart from Hymans Robertson.



The way to read the chart is this: you read above the line. By the way, there's a very confusing – there's a very confusing zero centering. Actually that black horizontal line is at minus 20 basis points, so you need to look at the actual zero of that line. I don't know why they draw it like that. But essentially, if the line through time, if it rises above – and you can see there's a green arrow saying "buy and pricing attractive". "Buy and pricing attractive" means effectively that there's a liquidity premium, or there's some kind of premium attached to the pension. So pensioners with a green line, and it's currently standing – that's in June '18, last year – standing at 40 basis points. That 40 basis points is a spread over gilts, meaning that pensioners are getting a good deal. And you might argue – you might argue that that's evidence of a liquidity premium attached to pensions.

On the other hand, if you look at – I think prior to March 16, when the actual matching adjustment regime was implemented, and before when it was being discussed, you will see actually ... there's a negative liquidity premium attached to pensions. Then you ask: well, how is that consistent – how is that [consistent with] 40 basis points? Let's be generous and say there's a 40 basis point liquidity premium; how is that 40 basis points consistent with 130 basis points that ULP is earning on its assets – in effect is earning on its assets?

So you have a difference of 130 minus [40] – you have 90 basis point which, over the lifetime of a pension, is a lot of money, because it's huge amount of money. How is that consistent? And it's odd because you're clearly – you know, if asset C has a liquidity premium, because it is illiquid, why shouldn't asset A, because it is illiquid?

The argument was given that the assets are illiquid just like pensions, therefore we can discount by more than the risk-free rate. Well, fine, but then you're acquiring these assets much, much cheaper than that. Pensioners are benefiting by 40 basis points over, by a spread. ULP is benefiting by 130. If you're then allowed to apply matching adjustment, well, in the old days, long-term capital, which was a famous blow-up, everyone knows about that, they would have borrowed at one rate, lent at another and waited the 10 or 15 or 20 years it took for it to – obviously it didn't last that long because they blew up. Matching adjustment allows you to take that now, so you can borrow at 40 basis points over, in effect lend via your corporate bonds at 130 basis points over, and you have made an immediate profit. So it's clearly – it's clearly something for nothing, unless we have a better explanation for that.

MR JUSTICE ZACAROLI: The – I mean, as Mr Moore pointed out, I used an inelegant colloquialism. What I meant by it was simply that, if you have an illiquid asset but you're holding it to term, then you're not subject to the risk of illiquidity. So any benefit that's built into the return on that asset that is ascribed to illiquidity is something you're getting without suffering the related risk.

DR BUCKNER: Right. So it's a different kind of something for nothing, but then, you see, that's not technically correct because there's always default risk. Equity release mortgages, for example, are subject to downturns, not just downturns in the property market, but the property market not going up by as much as forecast.

MR JUSTICE ZACAROLI: Yes, but there are two – as it's put, there are two attributes or two parts to the return. One is default risk and the other is illiquidity risk.

DR BUCKNER: Yes.

MR JUSTICE ZACAROLI: If you're not – of course you're suffering the default risk throughout, but if you're not suffering the illiquidity risk but nevertheless are having a return that is based upon that illiquidity risk, then do you take issue with the fundamental point that that is a benefit which can be used by a company, such as Utmost here, in order to reduce the – no – increase the risk rate on its liabilities.

DR BUCKNER: I'm saying [that] financial theory says that two identical products, two identical instruments or assets – ie they pay off the same in all states of the world – should have the same value. That's also an accounting principle as well.

MR JUSTICE ZACAROLI: So you would reject the entire proposition?

DR BUCKNER: I reject the entire proposition ... either there's a massive great 130 basis points illiquidity premium built into the corporate bonds assets that Utmost is holding, in which case pensioners are being a bit shafted, aren't they, because they're not getting that, they're only getting the 40 basis points; or the real illiquidity premium is actually the 40 basis points or less, and the 90 basis points difference is attributable to default risk. I would say it's the latter.

MR JUSTICE ZACAROLI: Thank you. Would that be a convenient moment for a break? We'll take five -minute break now.

DR BUCKNER: That's fine. Thank you. (11.45 am) (Short Break) (11.50 am)

MR JUSTICE ZACAROLI: Yes.

(3.2) DR BUCKNER: Thank you, my Lord. I propose to move to the second part of my point 3, which is the liquidity versus default risk. If you want to turn to the same document we were looking at, the next page on, I have labelled it, "One in half a million years".

MR JUSTICE ZACAROLI: Which table is that?

DR BUCKNER: It is –

MR JUSTICE ZACAROLI: Yes, the one in half a million.

DR BUCKNER: The one I've just given you, there's a blue chart of historical default rates and underneath that – yes, I think you're on the right page.

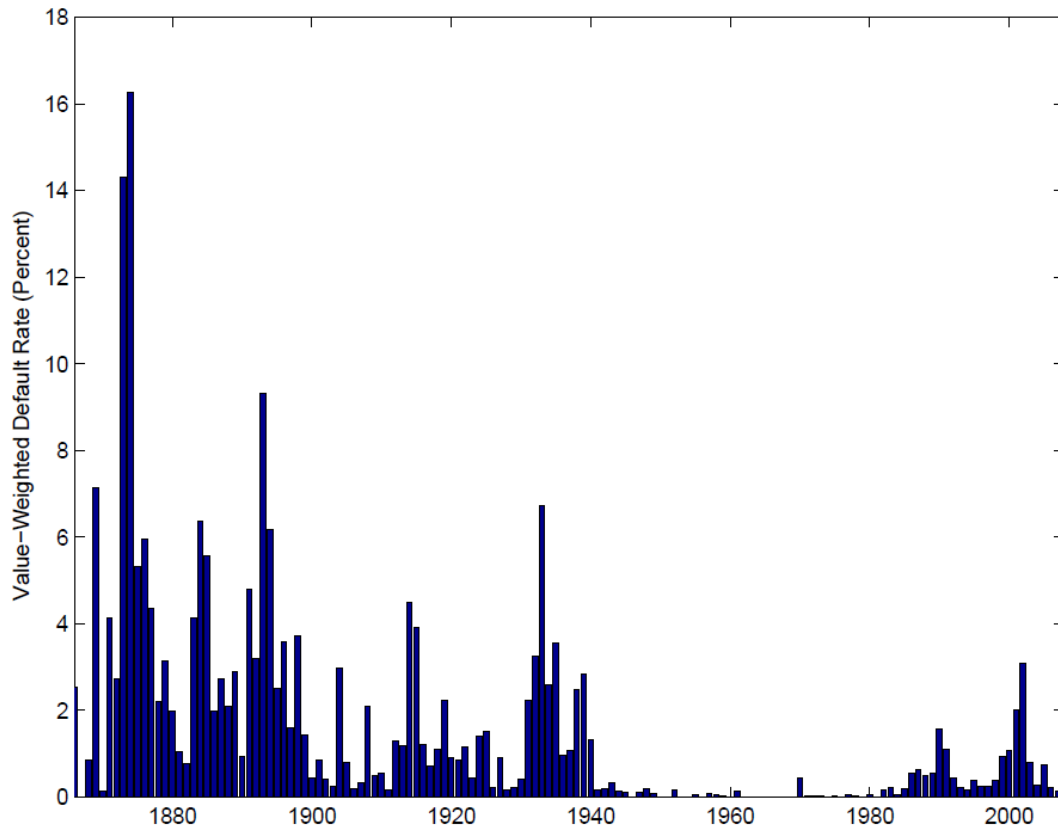


Figure 1. Historical Default Rates. This graph plots the annual value-weighted percentage default rates for bonds issued by domestic nonfinancial firms for the 1866–2008 period.

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: Underneath that I'm going to quote something, which is relevant, which is about Richard Feynman and the physicist's role in the Challenger disaster. As you may know, there was a space shuttle disaster in 1986 when the solid fuel boosters, the solid fuel rockets burnt through and the whole thing tragically exploded and seven astronauts lost. The Rogers Commission was appointed by President Reagan, I think it was then, to investigate the disaster and Richard Feynman the physicist was asked to give evidence. He's a great physicist and one of his great virtues is making quite complex sort of physicist things intelligible to laymen.

Here I take issue with the whole idea that a court cannot decide on complex and expert matters like matching adjustment. I don't think that's true.

Here's what Feynman said about the Challenger disaster. He was struck by management's ... I think it was [Nasa management's] claim, but it doesn't really matter. It was some management claim that: "... the risk of catastrophic malfunction on the shuttle was 1 in 10 to the power of 5, ie 1 in 100,000. Feynman immediately realised that this claim was risible on its face. As he described, this assessment of risk would entail that Nasa could expect to launch a shuttle every day for the next 274 years whilst suffering on average only one accident. Investigating the claim further, Feynman discovered that the 1 in 100,000 figure was stating what they claimed or which management claimed the failure rate ought to be, given that it was a manned vehicle and working backward to generate the failure rate of components".

The article adds he was bothered by the fact that Nasa claimed that the risk of catastrophic failure was necessarily - *necessarily* - 1 in 100,000. "As the itself was beyond belief, Feynman questioned

exactly what 'necessarily' meant in this context. Did it mean that the figure followed logically from other calculations, or did it reflect Nasa management's desire to make the numbers fit?"

Okay. Turning to – right, turning to a bit of bond mathematics, but nothing especially complex: how do you work out a bond spread, ie the risky spread; how do you work out a bond spread and the relationship between that spread and the probability. So for every bond spread there's an implied – or for every bond [spread] you [take], ie for that spread which corresponds to probability of default, there corresponds a probability of the default, and it's actually – there's – the calculation itself, it is detailed but the important bits of it are elementary.

If I have 100 bonds in my portfolio and I expect that one of them will default each year, then that's a 1% risk, so I will demand – I will demand an extra 1% compensation within the spread. So I get an extra 1% coupon each year which compensates me for the one bond that defaults each year and the 1 in 100 risk.

So there it is. It's a very elementary – there's a very elementary calculation which takes you from probability to spread and, by implication, probability to matching adjustment. So if you start with the probability that you think that this firm will default, if you start with that, you can then work out a spread that you think will correspond to default risk. If the market observes spread is greater than that, it then follows, doesn't it, you would think, it follows that the rest must be attributable to liquidity. What else could it be. There must be a residual element. That's if you start – that's if you start with something like the one in half a million years number. So, if you look at a firm with 160/170% capital coverage ratio, that's a very, very long time; yes? If you start with that, you get a very, very small spread.

If, on the other hand, you say – and I was taught th[is] way – I was taught that there's very little liquidity.

In fact, a quick story. I managed a very large bond [port]folio over the crisis and it had a very, very large lumpy position, about a billion in some French bond. I think it was one of these municipals where it is sort of guaranteed by the government but you're not quite sure, and it was a floating rate bond and it was very, very illiquid, and we tried for six months to get that off the books. It is very easy to tell what the spread corresponding to risk was because a floating rate bond linked to LIBOR will always be priced at 100. So what did we get for that bond? Our head trader eventually got – he dumped it on the market, he sold it off, and it was something like 99.95, something – something ridiculous, so it was a tiny, tiny spread. And my whole experience of bond trading is that, yes, there is a liquidity spread, but typically that's take-up in the bid and offer, so when traders are buying and selling bonds to each other, the liquidity is already built in there, in the spread, and that's typically tiny. It's nothing like 130 basis points, which is a matching adjustment spread.

So the question is – oh, yes, I mentioned the HBOS collapse as well. I was sort of involved in that. I left to manage that bond portfolio in 2007, but in 2008 the Basel advanced internal ratings -based model came in and that was meant to calculate risk of default to 1 in 1,000. So 1 in 1,000 years, which takes you back to Battle of Hastings or something. HBOS – and it's all public record – implemented that in February 2008 and we all know what happened afterwards, where eight months later they had to go cap in hand to the regulator, to the bank, and they were taken over by Lloyds.

So I don't – I am a strong supporter of models and I believe in the maths underlying them, but the numbers you put in have to be right. The legacy of HBOS was that there was a sort of secret portfolio of loans. It was actually worthless, as it turns out, based in Ireland, and there's really nothing in it, but that was sort of kept secret from a lot of the senior management and that risk – the risk of that defaulting, which was high, didn't go into the model, so it wasn't 1 in 1,000 years; it was 1 in one year, because it defaulted eight months after they implemented the model.

Now, the point I'm making here is that if you start with – if you start with an invented probability, then you will get a low number for your default spread. If you take the whole of the default spread, if you take the whole of the market observed spread, you may get a number that actually indicates a very high probability of default. It all depends on where you start.

So where do the PRA start? How do they come up with these numbers which, on the face of it, if we go back to this red and blue line, you know, on the face of it, imply remote – utterly remote probabilities of default which take you back to Neanderthal or human evolution times. How do they come up with these numbers?

It is a matter of public record – I'm not giving away any confidential here – that Solvency II was originally a market consistent regime. The purpose was to align insurance – insurance valuation and risk management with modern financial theory, ie the theory that began in the 9050s. That was proposed in 2009 and then there was a study after that – again, the results of that are public domain – that found that basically the UK insurance life industry was pretty much insolvent. There were a couple of firms on the brink and – yes, there were a couple of firms on the brink and others which were not on the brink but were not well capitalised. So, you start with that ... you start with the financial theory that here's the whole of the spread in the portfolio, your risky assets. That looks like a lot of firms are going to go bankrupt, or are close to bankruptcy.

So what happened was a pile of lobbying. Here I'm sort of veering into confidential territory but I think there are – there was one article published in 2013 which said, yes, there was a lot of lobbying. I think it was Sharon Bowles, who was an MEP, she was strongly involved in that from the European Parliament side. And the principle of matching adjustment was agreed. Then the rest is history.

You start with the position now that, well, clearly, clearly, and we come back to this Feynman – the management, Feynman's management saying "necessarily". Necessarily the UK industry can't be bankrupt. Any sort of evidence to suggest it's not is just wrong. So let's start with the position that all firms have at least a solvency capital coverage ratio of 100%. You start from there, then of course the rest follows. You can work out an implied probability of default – sorry, you can work out an implied spread from that and then work out, given the [implied spread] or that "fundamental" spread, you can subtract that from your observed bond spread or asset spread and you get the matching adjustment. So that is the story of Solvency II

Then I guess we come back to the fire safety problem, the fire certificate problem. There is strong evidence – there is strong evidence, both from acknowledged experts and authorities, and kind of common sense, that there's a risk to the cladding. It can catch fire and it's dangerous. On the other hand, the fire department is saying, "No, no, this is not a matter for courts. It's not – you know, we are the fire department. You know, we must rely on our own rules. You know, we cannot discuss the true safety of cladding". So I'll leave that point there. I will go on. There's one other. Above the Feynman quote – I mean, there is other evidence you can rely on to work out the probability of default. So if you turn back a page, above the Feynman quote there's a blue – there's a graph, a chart ...

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: ... of default rates. As you can see from that, it goes all over the place. If you look at the last part of the nineteenth century, it was horrific, and the basic reason for that was the end of the 19th century economically was a period of great deflation and a lot of hardship for people who had borrowed money. You can see default rates are through the roof. The period just before 1940 is of course the great depression, but, as you see, it's almost a walk in the park as compared to what happened in the late 19th century. Then after that you see this puzzling period lasting until about 1980 with very, very [low defaults] and [there are] lots of theories about this.

One plausible explanation is you have Keynesian economics coming in, where you just say, "Well, we're going to have no more great depressions, let's just sort of drop interest rates as soon as there's any sign of any problem". That appears to work for a long time, but I mean, I lived through – many people here won't – the 1970s and I was a student then, and you'd get the train each term; the price of the train would go up significantly each term. So the cost of that period of low default rates, of low insolvencies was obviously inflation. You're not likely to go insolvent if the amount you have to pay back is reducing in real [*sic* – nominal intended] terms each year, or each month.

You then see it come back, 1980 to 2000. The 2000 crisis not as bad as the 19 – sorry, sorry. This graph gives up – I'm pretty sure that 2000 period actually covers the 2001 crisis, not the 2008. I don't have numbers for 2008. My understanding is the default experience has not actually been that bad since the crisis, but we kind of all know why, we know [what] happened. The Central Bank stepped in.

Anyway, my fundamental point is this: I've put this to people before, that, "Look, you can – depending on which period you choose, the default risk experience is either very low or very high; which do you choose?" People would say, "Ah yes, but obviously the 1880s or the 1930s was a wholly different thing. It couldn't happen again". I say, "Well, if you really are claiming there's a 1 in 1,000 year risk, or 1 in 100,000 years, or half a million years or a million years, if you really are saying that, well, then, that stuff could happen again. That stuff really could happen again. Why shouldn't – in the current situation, when we have an extremely low interest rate environment and there is potentially deflation, why could we not have something like the 1880s again? So that's all I have to say there. Equity release and ground rent. I'll talk quickly about equity release because I was involved slightly for quite a few years –

MR JUSTICE ZACAROLI: How relevant is it to the point I'm on, which is matching adjustment?

DR BUCKNER: Sorry, which, the equity release or the –

MR JUSTICE ZACAROLI: Yes, the equity release point you're about to go on.

DR BUCKNER: I'd like to talk about that because if the PRA are saying, "We are the PRA, we must abide by our own our own rules", well, the PRA's own rules involve internal consultation, and the equity release case was a very important case, where it took three years for economic theory to prevail. If you look at history, there's a whole series of consultation papers which turned out in the end with the PRA saying, "Actually, sorry, we got this wrong, we allowed firms to calculate default risk based on projection of house price growth. Actually that's totally wrong, we should base it on something – on net rental yields " –

MR JUSTICE ZACAROLI: So your point is that there's been another occasion in the past when the PRA said everything was fine but turned out to be wrong about it?

DR BUCKNER: Absolutely – well, it's not just that. 2008, the HBOS case, 1 in 1,000 years and they blew up the same year. The equity release was a case for matching adjustment where PRA said, "Yes, it's totally fine, no risk here, perfectly okay to project house prices at 3% per year in order to get your default rate, and hence your matching adjustment, your implied matching adjustment".

Three years of sort of intensive consultation later, sort of common sense prevails and they said, "We were wrong". One firm's share price collapsed as a result. So, yes, your point being that there is at least one case, I think quite a few more, where the PRA says, "No, the fire cladding is perfectly, perfectly safe, just trust us ", and then the next thing they say is, "Sorry, the building is going to burn down". Yes, that's all I have to say on equity release. Ground rent is sort of coming up because that's another – well, that hasn't happened yet so let's leave that alone. I'm conscious of time. It's 12.05. The only other points really were the actuarial independence or the independent expert point.

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: Can I cover that briefly.

MR JUSTICE ZACAROLI: Yes.

(4) DR BUCKNER: It is more subtle than saying that the independent expert is both paid for and appointed by the firms. It's more subtle than that. Well, actually, it's not more subtle than that. There's something called the section 166 which the PRA uses. The PRA used to have – I can't remember the name of the previous regime – where they asked the firm to audit itself. The firm would then get in bed with its favourite auditor and the results of these sort of self - audits were always uniformly optimistic and good. That was changed. That was changed three or four years go and the principle then was the PRA both appoints and pays for the auditor out of their own selected and preferred auditors. They then get money back from the firms.

So in reply to the point – one of the submissions said: well, that's the only way we can do it. Well, there are many ways you can do it. You could get just someone completely independent, like, I don't know, Professor Dowd, or me, to say, "Well, here are the auditors we prefer, here's how you should

do it, let's do it that way". So there are other ways of doing it. That's the first point. The second point, and this brings me to the last page, pretty much the last page of my first submission. I will just read this out. This is very pertinent to Equitable, because I have a fear we're going to be seeing the same thing again. So Equitable could be another Equitable:

"In the aftermath..." (I wrote this) "... of the Equitable Life case there was much soul-searching [in] the actuarial profession and the government commissioned Sir Derek Morris, the former head of the Competition Commission, to look into the failings of the actuarial profession and make recommendations for reform." This is around 2005, I think: "The message from his report was unequivocal and hard-hitting. There needed to be greater scrutiny of actuaries' performance and broader education and training." Note the last bit, education and training. I'm now quoting from the Morris report: "In its interim assessment the review highlighted concerns about the process by which the profession has sought to keep its syllabus and associated teaching materials up-to-date. Thus, for example, the perceived failure to adopt latest developments in financial economics and financial markets was seen in large part to stem from the role played by entrenched commercial interests in the development of the profession's education policy."

Two points being made there: one, that the profession is just behind on it, you know, a discipline that emerged in the 1950s was at that time not being taught, and there was an insularity that constrains the extent and effectiveness of input from academics, other professions and those in wider fields of practice. So there's insularity and also a ... perceived commercial interest in that.

I'll read on: "The UK now finds itself ['now' being 2004] in a position where there has been a flight from and a resistance to a range of financial products which arguably consumers should purchase to maximise their lifetime economic wellbeing. It is not unreasonable to argue that of all of those involved actuaries were the most appropriately trained experts, who should have provided the expertise necessary to avoid this situation, but they were not sufficiently innovative. They remained too locked in the environment of the 1970s and 1980s [I would say 1950s or 1940s] and too persuaded of their own abilities."

So there is another point to make here about the independence of the independent expert. To my knowledge, it is always an actuary who is appointed to that role. Always. Actuaries still do not – the younger actuaries will have benefited from changes to the syllabus in the early 2000s, so the more recently qualified actuaries will know some of this, but in my view not all of this. The less recently qualified will know none of this.

My experience has been that actuaries are brilliant at doing compound interest and longevity calculations. I mean, that's what they're for. That's what actuaries do. They look at longevity and morbidity and the statistics on that. They have very little training in modern financial theory, and that is a problem in my view, and it raises questions – the whole questions about the independence of the independent expert. That's all I have to say on independence.

MR JUSTICE ZACAROLI: And your fifth point?

DR BUCKNER: My fifth point was going to be on the – yes.

MR JUSTICE ZACAROLI: You have made the point that it's 21%, not 27%.

(5) DR BUCKNER: Correct. My main point is 21, not 27. That's right. So if we turn to the second page, I think it is. Turn to the second page. Now, I did have some correspondence with Freshfields on this and they were saying – I wasn't sure what they were saying. They just said it is the wrong number and the PRA say: well, it has been audited. But, to my knowledge, the table you always depend on for this is conveniently named S.22.01.21.

Utmost Life and Pensions Limited Impact of long term guarantees and transitional measures S.22.01.21		Amount with Long Term Guarantee measures and transitional	Impact of transitional on technical provisions	Impact of transitional on interest rate	Impact of volatility adjustment set to zero	Impact of matching adjustment set to zero
ALL AMOUNTS SHOWN IN £ THOUSANDS		R0010	R0020	R0050	R0090	R0100
Technical provisions		1,477,675	33,038	0	0	64,770
Basic own funds		117,673	-33,002	0	0	-64,777
Eligible own funds to meet Solvency Capital Requirement		114,963	-33,002	0	0	-97,067
Solvency Capital Requirement		64,579	0	0	0	19,328
Eligible own funds to meet Minimum Capital Requirement		86,896	-33,002	0	0	-69,000
Minimum Capital Requirement		21,114	0	0	0	1,347

That's on page 76 of the SFCR, which I think wasn't a submission by anyone, but I've copied it from this. This is a very helpful table. I use this a lot and if I look at the eligible own funds to meet solvency capital requirement, that's given at 114.9 million.

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: If I look at the impact of matching adjustment set to zero, and if I read that as meaning exactly what it says, ie with the impact of setting it to zero, it is 97 million. If I then subtract that 97 from 115, then divide by the solvency capital requirements, which goes up by 19 million, I get 21%. Anyone can check that calculation. I'm sure it's correct.

MR JUSTICE ZACAROLI: Do you want to take me through that slowly again?

DR BUCKNER: Yes, sorry. So, how do I get to 21%? I start on the – what is the third row –

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: – which is eligible own funds – not basic own funds, you have to have eligible own funds is what it says, it's eligible. I then get 114,963K [i.e.] 114.9 million of eligible own funds.

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: I then look across there and I look at the same number, you see it is minus 97.06 million, which is, in the title of that column, "Impact of matching adjustment set to zero". That's 97.06 million. I then subtract that 97 – because it is a minus, and it always is a minus – from 114.9 and I get something, it's around 18, I think. I then divide that number by the solvency capital requirement after matching adjustment set to zero. So – sorry, is this too fast?

MR JUSTICE ZACAROLI: No, go ahead.

DR BUCKNER: So I take 64.579 million, add 19.328 million to it and then I get something which is probably around 84. I then divide the first number I got by the second number and that gives me my 21%. Which is kind of obvious. If you have 115 million and you take off 97, which is nearly 100, you are going to only have about 15 or 18 million left, which clearly has to be much, much smaller, ie 21% of the SCR. So, now, I had a brief correspondence with Freshfields who said, "Ah, but that number includes the impact of transitional on technical provisions".

Well, I suspect – I'm not entirely sure that the SFCR has been correctly calculated here. I think they may be right but for the wrong reasons. I think they shouldn't – they have probably taken the impact of the transitional and added that to the 64.7, I think. I mean, it's not for me to judge how they got their number, but the point is, that table is the auditor table and that's the only one I can go by, plus the table I gave you here with the blue line and the red line, this is all based on the very same table for all those different firms.

MR JUSTICE ZACAROLI: Yes.

DR BUCKNER: So that's the first point I was going to make. On the point – in light of the more recent – so the submission this morning is – sorry, was that – does that make sense?

MR JUSTICE ZACAROLI: Yes, thank you.

DR BUCKNER: The submission this morning is the subordinated loan. There's already a bit of sub-debt – tier 2 sub-debt on the balance sheet of ULP. I take it that's not the same sub-debt referred to in the assurance, the undertaking given to the PRA to recapitalise. There will be another number that comes up. I don't like this – some firms do it and, to be honest, the firms that do it are on the right-hand side of this red line, rather than the left-hand side. There's a provision of Solvency II that says that sub-debt – subordinated debt, which is not eligible as equity in the statute report, it's not included as capital for statutory purpose, is included as capital for regulatory purposes. So you have this sort of weird thing of the – [regulatory] capital being different from statutory capital.

If you go to the very first page of the document, which is an explanation of change from UK GAAP statutory to solvency, that's another really useful table you get in the SFCR. It shows you what you start at with the UK GAAP of valuation of assets, valuation of technical provisions. You will then see on the UK GAAP side they have extracted 35, another 64 and 31.9 to give 35.7 million. I am not sure what "funds for future appropriations" is. I've no idea. I take it [that] it means some kind of fund lying around that would not count as distributable capital, ie not for shareholders' purpose, but can be raided by policyholders in event of insolvency. I think that's what it is. Perhaps someone from the other side can confirm.

You have that 35 million in there. It is kind of okay because sub-debt gets eaten up by policyholders if there's a default that sort of breaches the MCR. It's kind of okay. What I don't like is I only tend to see it when sort of bad things are sort of happening. To me, it's an early warning signal. It's a bit of a red light. Also what I don't like is normally the sub-debt comes externally. It looks to me here as though UUG, which is the total parent – the ultimate parent company, has actually given that capital to ULP in return for something – well, in return for the liability of course. So what you have is the parent company sort of lending money to the subordinated company at an interest rate of 7%. And another thing is [that] 7% is kind of close to junk rate. If you say: well, this firm has a one in a half a million years' probability of a default, then why is its sub-debt trading at 7%? That's another thing I have a kind of problem with. I'm probably venturing on to territory I know little about here, but that's really all I have to say.

MR JUSTICE ZACAROLI: Thank you very much, Dr Buckner. That's very helpful.

DR BUCKNER: Thank you.

[...]

MR MOORE: My Lord, in my submission, the objections that Dr Buckner has produced should not lead your Lordship to having any doubt as to the appropriateness of sanctioning this scheme. Not a lot, in my submission, of what Dr Buckner told you was particularly helpful to your Lordship. The submission that I made to your Lordship is that, properly construed, Part VII requires the court to exercise its discretion against the background of the regulatory regime as it is, not as some people might want it to be. Of course that's not to say that a court, in some other forum, could form a view on the appropriateness of the matching adjustment, as any court deals with matters on expert evidence, but it does so on the basis of proper evidence, produced by experts, able to be cross-examined on their reports. My Lord, that is just outside the purview of a Part VII transfer scheme. The various extracts that Dr Buckner has produced are not properly evidence. They're simply extracts from speeches that have been given. They're not experts in the sense that the court would understand expert evidence to be. So, my Lord, my primary submission in relation to the matching adjustment is that it is all unhelpful and irrelevant to your Lordship's decision. My Lord, the questions that your Lordship directed at Dr Buckner, with respect, were the right questions, which is: what is the relative strength of Equitable and Utmost, and is there a significant solvency condition of Utmost which might cause the court to pause in considering the proposal?

Now, of course the court has seen the views of the independent expert on the transfer, the TIE, where he concludes that there is no material adverse effect on the security of the transferring policyholders. My Lord, I thought it might help if your Lordship were to just look in the independent expert's report at the table at 2.3, which your Lordship finds at page 19 of the supplementary report of the independent expert.

MR JUSTICE ZACAROLI: Was that page 19?

MR MOORE: My Lord, yes, it's at page 19 - -

MR JUSTICE ZACAROLI: Yes.

MR MOORE: -- but perhaps one -- there's an earlier table, which is ELAS's pre and post scheme position.

MR JUSTICE ZACAROLI: Yes.

MR MOORE: That's at the top of page 17. Your Lordship sees the capital ratios pre-scheme and post-scheme for ELAS and Utmost. As you can see, for the policyholders who remain in ELAS, there is an improvement in the solvency coverage ratio. For the policyholders who move from ELAS, there is an improvement in their solvency coverage ratio, but there is a drop of some 18% for the existing Utmost Life policyholders. Then, my Lord, if one looks at the table at 2.3, your Lordship can see the balance sheet projections, the Solvency II balance sheet projections for Utmost Life and Pensions over the course of the next four years. Your Lordship sees them increasing really quite significantly.

My Lord, this of course proves the inwardness of the point that your Lordship suggested to Dr Buckner, focusing, as is right, on the particulars of this case and not general questions of policy about the matching adjustment, that because of the step change and significant transformation in the balance sheet of Utmost that is caused consequent upon the scheme, the matching adjustment and impact of the matching adjustment drifts very quickly into immateriality.

My Lord, taking the figures for the impact of the matching adjustment from Dr Buckner's 22 November paper, which your Lordship will find on the fourth page, your Lordship will see the two portfolios, the annuities and the funeral plan, which had the matching adjustment, and your Lordship will see the BEL with the matching adjustment and without the matching adjustment. So it is 555 million with the matching adjustment, 619 million without the matching adjustment. The difference is 64.6 million, my Lord. So that in nominal terms is the effect of the matching adjustment. So if my Lord then plays that against the columns in 2.3 and you deduct from your eligible own funds -- take, for example, the figure as at 1 January, of this coming year, of 301 -- you deduct 64 and even allowing, and it is a big allowance in favour of Dr Buckner, that you also take into account the change in solvency capital requirement, which I am instructed is approximately £18 million, you will see that after the scheme becomes effective we are over the 100% solvency cover ratio and that that improves, even if there were no change in the amount of the matching adjustment over the course of the next four years, that position gets stronger and stronger and stronger.

Of course, the assumption that there is no change is actually not one that your Lordship could make because it is a closed annuity book and it's running off. So in five years' time it will be smaller than it is currently and therefore the matching adjustment will be smaller. So, my Lord, focusing on this case and assuming, against ourselves, that there's no matching adjustment, it has no material effect on the security and solvency of Utmost. So, my Lord, in my submission, even if your Lordship were wholly persuaded, which in my respectful submission your Lordship couldn't remotely be persuaded, by the submissions by Dr Buckner as to the correctness or otherwise of the matching adjustment, it makes no practical impact. It makes even less of a practical impact on Dr Buckner in his capacity as a policyholder by virtue of the reinsurance arrangements. My Lord, the only other point I would make in relation to Dr Buckner's submissions is that he was telling you the history of the evolution of the matching adjustment and made the point that there were a whole slew of UK insurance companies which were, in his words, bankrupt. Well, my Lord, that simply isn't so. Dr Buckner is confusing falling below the level of your solvency capital requirement with Insolvency Act insolvency. As I indicated to your Lordship, your Lordship has the point that the risk margin over and above the best estimate of

your liabilities is quite enough to ensure that the company is solvent. So that is, with respect to Dr Buckner, a bit of an exaggeration. My Lord, so far as the position in relation to the independence --

MR JUSTICE ZACAROLI: I don't think I need to hear from you.

MR MOORE: I would just give your Lordship the reference in the Allied Dunbar case. It's in tab 13 of the authorities bundle and it starts from paragraph 15 through to paragraph 18.

MR JUSTICE ZACAROLI: Can I just ask this on the matching adjustment issue: is there any other policyholder who has objected on the same basis, or a similar basis?

MR MOORE: No, my Lord. No. No, my Lord, this is obviously a bete noir for Dr Buckner, but nobody else has raised this particular point. My Lord, in our submission, that is really the long and the short of it. In terms of a generalised debate about the matching adjustment, this is not the correct forum. In any event, even if it were right in this case, it makes no material difference to the security of policyholders in general and, in particular, it makes no difference at all to the position of Dr Buckner. So, my Lord, that's all I wanted to say on the matching adjustment.

MR JUSTICE ZACAROLI: Thank you.