

Second Supplemental Report of the
Independent Expert on the Proposed
Insurance Business Transfer Scheme from
the UK Branch of Sompo Japan Insurance
Inc. to Transfercom Limited under Part VII of
the Financial Services & Markets Act 2000

10 November 2010

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Section 1: Introduction & Scope

The Independent Expert

- 1.1 I have been appointed by Sompo Japan Insurance Inc. ("Sompo") as the Independent Expert in connection with the proposed transfer ("the Proposed Scheme") of the vast majority of the business of the UK Branch of Sompo Japan Insurance Inc. ("Sompo UK") to Transfercom Limited ("Transfercom"), which is part of the Berkshire Hathaway group.
- 1.2 My appointment as the Independent Expert in connection with the Proposed Scheme was approved by the Financial Services Authority ("FSA") on 2 November 2009. In connection with this appointment there is an engagement letter in place between Towers Watson Limited ("Towers Watson") and Sompo, although the costs and expenses relating to my appointment are ultimately being shared between Sompo and Transfercom.
- 1.3 My view on the effect of the Proposed Scheme is set out in my Independent Expert report dated 21 January 2010 (my "Independent Expert Report").
- 1.4 Subsequent to the completion of my Independent Expert Report, a number of new pieces of information became available. I therefore produced a supplemental report dated 8 March 2010 (my "Supplemental Report") in order to opine on whether the conclusions set out in my Independent Expert Report had changed in light of these new pieces of information. My Supplemental Report confirmed that my view on the effect of the Proposed Scheme remained unchanged.

Scope of my report

- 1.5 Following completion of my Supplemental Report, an application to approve the Proposed Scheme was listed to be heard by the Court on 26 March 2010. Before the date of that final hearing, a number of transferring policyholders raised certain objections to the Proposed Scheme. These objections had not initially been raised in response to my Independent Expert Report and were therefore not addressed in my Supplemental Report.
- 1.6 At the request of the FSA, an adjournment of the application for approval of the Proposed Scheme was requested. The directions of the Court are embodied in the Order it made on 26 March 2010, which is included as Appendix A to this report.
- 1.7 On 1 April 2010, and in accordance with the Court's Order, three written statements of objection to the Proposed Scheme were received. These were received from:
 - Reynolds Porter Chamberlain LLP on behalf of Riverstone Management Limited and Riverstone Insurance (UK) Limited (collectively "Riverstone");
 - Fox Hartley on behalf of Axa Corporate Solutions Assurance ("Axa"); and
 - Maitland Hudson & Co LLP on behalf of La Réunion Aérienne ("LRA").

- 1.8 On 22 April 2010 a further written statement of objection to the Proposed Scheme was received from ACE Overseas General, which comprises the operations of ACE Underwriting Agencies Limited and ACE European Group Limited (among others) (collectively "ACE").
- 1.9 In accordance with a letter from Lovells dated 19 April 2010 and, subsequent to the receipt of ACE's objections, a further letter dated 23 April 2010 (together the "Instruction Letters"), both of which are included in Appendix B to this report, I have been instructed on behalf of Sompo to produce a second supplemental report in light of these objections insofar as these relate to the Independent Expert Report or the Supplemental Report.
- 1.10 I have reviewed the objections received and the purpose of this report (my "Second Supplemental Report") is to set out my comments on, and responses to, these objections. I have also considered whether there are any matters that I have addressed in either my Independent Expert Report or Supplemental Report (collectively my "Previous Reports") that require amendment, amplification or supplemental work in respect of these objections.
- 1.11 In order to be of most assistance to the Court, I have structured this report so that I address each policyholder's objections in turn (insofar as they relate to matters within my expertise), cross-referencing my other responses in the event of overlap.
- 1.12 Further, in accordance with the instructions I received in the Instruction Letters from Lovells, I have not addressed issues raised by Riverstone, Axa, LRA or ACE which relate to requests for documentation or underlying data, save, in certain circumstances, to indicate that certain objections are, in fact, such requests for documentation or underlying data.
- 1.13 This Second Supplemental Report must be considered in conjunction with my Previous Reports. The reliances and limitations set out in my Previous Reports also apply to this report, together with the additional reliances and limitations which are set out throughout this report. Any defined terms used in this report have the same meaning as in my Previous Reports.

Terms of reference

- 1.14 My Independent Expert Report, my Supplemental Report and this Second Supplemental Report in combination are intended to aid the Court's deliberations as to whether the Proposed Scheme should be approved. In reporting on the Proposed Scheme in accordance with Part VII of the Financial Services and Markets Act 2000 ("FSMA"), I owe a duty to the Court to help the Court on matters within my expertise. This duty overrides any obligation to any person from whom I have received instructions or by whom I am paid. I have complied, and continue to comply, with this duty.
- 1.15 In preparing this report I have taken account of the following:
- Part 35 of the Civil Procedure Rules
 - The Practice Direction supplement to Part 35 of the Civil Procedure Rules
 - The protocol for the instruction of experts to give evidence in civil claims drafted by the Civil Justice Council

- Guidance in paragraphs 18.2.31 to 18.2.41 inclusive of the FSA's Supervision Manual which sets out the FSA's guidance on the form of the scheme report.
- 1.16 I am required to comply with professional guidance issued or adopted by the Board for Actuarial Standards in the UK, including the current version of Guidance Note 12 ("GN12"). This Second Supplemental Report, when taken together with my Previous Reports, complies with UK professional guidance, subject to the principles of proportionality and practicability where these principles are applicable.

Reliances & limitations

- 1.17 In carrying out my review and producing this report I have relied without independent verification upon the accuracy and completeness of the data and information provided to me, both in written and oral form. Where possible, I have reviewed the information provided for reasonableness and consistency with my knowledge of the insurance and reinsurance industry.
- 1.18 A draft of this report has been made available to the FSA, whose comments have been taken into account.
- 1.19 No limitations have been imposed on the scope of my work and the opinions in this report about the Proposed Scheme are mine, based on the information provided and the answers to any questions I have raised.
- 1.20 This report has been prepared on an agreed basis for the purpose of reporting on the Proposed Scheme, and must not be relied upon for any other purpose. It must be considered in its entirety as individual sections, if considered in isolation, may be misleading. It must also be considered in combination with my Independent Expert Report dated 21 January 2010 and my Supplemental Report dated 8 March 2010. This report is subject to the terms and limitations, including limitation of liability, set out in my firm's engagement letter of 2 November 2009.

Legal jurisdiction

- 1.21 This report is governed by and shall be construed in accordance with English law and the parties submit to the exclusive jurisdiction of the English courts in connection with all disputes and differences arising out of, under or in connection with this report. If any part of a provision of this report is held invalid, illegal or unenforceable then the remainder of such provision shall remain valid and enforceable to the fullest extent permitted by law.

Structure of this report

- 1.22 The structure of this report is as follows:
- Section 1 summarises the scope of my work as the Independent Expert
 - Section 2 summarises my overall conclusions

- Section 3 addresses the objections raised by Reynolds Porter Chamberlain LLP on behalf of Riverstone Management Limited and Riverstone Insurance (UK) Limited (collectively "Riverstone")
- Section 4 addresses the objections raised by Fox Hartley on behalf of Axa Corporate Solutions Assurance ("Axa")
- Section 5 addresses the objections raised by Maitland Hudson & Co LLP on behalf of La Réunion Aérienne ("LRA")
- Section 6 addresses the objections raised by ACE Overseas General, which comprises the operations of ACE Underwriting Agencies Limited and ACE European Group Limited (among others) (collectively "ACE").

Section 2: Summary & Opinion

Summary of the Proposed Scheme

- 2.1 The effect of the Proposed Scheme would be to transfer the vast majority of the business of the UK Branch of Sompo Japan Insurance Inc. ("Sompo UK") to Transfercom Limited ("Transfercom"), a subsidiary of the Berkshire Hathaway group.
- 2.2 My comments and responses to the objections raised, as set out in this report, focus solely on the likely effects of the Proposed Scheme on the three distinct sets of affected policyholders, namely:
- The policyholders remaining with Sompo
 - The policyholders transferring from the UK Branch of Sompo to Transfercom
 - The current policyholders of Transfercom.
- 2.3 For each group of policyholders my considerations on the likely effects of the Proposed Scheme have included the impact on:
- The security of policyholders' contractual rights
 - The levels of service provided to policyholders.

Summary of findings

- 2.4 In forming my view on the effect of the Proposed Scheme, I have considered the likely effects of the Proposed Scheme on the level of security enjoyed by the affected policyholders. I have also considered the potential effects of the Proposed Scheme on the other factors which can impact security or service levels to the affected policyholders.
- 2.5 Since the finalisation of my Previous Reports, and in response to the objections raised, I have obtained an independent legal opinion on the operation of the reinsurance contracts with NICO, including the circumstances in which Transfercom could lose the benefit of the reinsurance cover and whether the reinsurance contracts would survive the sale of Transfercom. Based on my understanding of this legal opinion, it is my opinion that it is appropriate to assume that the reinsurance contracts with NICO will be fully effective (except if NICO becomes insolvent) when opining on the likely effects of the Proposed Scheme on the affected groups of policyholders.
- 2.6 I have also obtained independent legal input into some other areas including:
- The impact of some additional clauses added to the NICO reinsurance contracts
 - Objections raised around the issues of set-off rights and OFAC sanctions.

2.7 For the analysis which supported my Previous Reports:

- I made no specific allowance for the investment return to be earned on the capital levels of Transfercom during the run-off of claims, as I assumed that this was counterbalanced by also not considering the counterparty credit risk in respect of NICO and the liquidity and credit risk in respect of the US\$30 million bond holding. In my view this was a reasonable assumption.
- I treated the security levels of both books of business as identical and did not consider their very different payment profiles. This simplification represented a conservative view of security levels for the transferring policyholders and had no material impact on my assessment of security levels for the existing policyholders of Transfercom.

2.8 A number of the objections received have centred around two issues:

- A requirement for an explicit treatment of investment returns, counterparty credit risk and liquidity risk.
- A requirement to understand in more detail the security level of the transferring policyholders and the time frame over which the assessment of this level is made.

2.9 In response to the objections raised I have updated my modelling approach in three main ways:

- First to alter the modelling assumptions to give explicit consideration to investment income and counterparty credit risk (and to discuss in more detail liquidity risk). This is described further in Sections AC.10 to AC.16 in Appendix C.
- Secondly to present the results of the model to make allowance for the different expected future payment periods of the two sets of policyholders, as described further in Sections AC.17 and AC.18 in Appendix C.
- Finally I have updated my assessment of reserve uncertainty for developments since the effective date of my Previous Reports. In light of the requirements of the updated approach and presentation this has included the need to allow for the payment pattern of the two sets of reserves (for the transferring and current business). This assessment is set out in Sections AC.19 to AC.40 in Appendix C.

Security of policyholders remaining in Sompo

2.10 With respect to the security of the policyholders remaining in Sompo, I am not aware of any new pieces of information which are relevant to these considerations and which have become available since the completion of my Supplemental Report.

2.11 I therefore consider that the conclusions set out in Section 2.7 of my Independent Expert Report remain applicable. My opinion therefore remains unchanged that the financial effect of the Proposed Scheme on the security of the policyholders remaining in Sompo will be de minimis and their security levels will remain effectively unchanged, given the small decrease

to the total liabilities of Sompo as a result of the Proposed Scheme and the minimal net effect on capital.

Security of policyholders transferring from Sompo UK to Transfercom

- 2.12 I set out below my main conclusions, which are also set out in the body of this report and Appendix C.
- 2.13 My assessment of the Post Scheme security of the transferring policyholders (and of the existing Transfercom policyholders) was based around the level of policyholder protection required for FSA authorised companies under the ICA regime. Under this regime, security has to be at least equal to a 99.5% confidence level over a one-year timeframe that the value of assets of the company will exceed the value of liabilities. This implies a 0.5% chance of failure in that the value of the liabilities do not meet the value of the assets after one year.
- 2.14 FSA guidance is that companies can select a longer time horizon than one year for this assessment, in which case the percentage confidence level does not have to be as high, as it relates to a longer period. A longer time horizon is particularly common for non-life firms in run-off where the typical approach is to use a time horizon over the entire outstanding duration of the business; so an assessment is made of whether the company will meet all of its liabilities over the full period until its last liability has been met. I will sometimes refer to this as a confidence level “on a run-off to ultimate” basis in this report.
- 2.15 Under this “run-off to ultimate” approach the standard rule of thumb when setting the required confidence level percentage is to reduce the 99.5% confidence level over a one-year timeframe by 0.5% for each year that the mean outstanding term of liabilities is greater than one, up to a maximum of five years.
- 2.16 Hence, acceptable security levels are as shown in the table below.

<i>Mean outstanding term of liabilities</i>	<i>Confidence level</i>	<i>Chance of failure</i>
1	99.50%	0.50%
2	99.00%	1.00%
3	98.50%	1.50%
4	98.00%	2.00%
5 or greater	97.50%	2.50%

- 2.17 Taking the example of a book of business with a mean outstanding term of three years, the acceptable chance of failure under the FSA’s ICA regime is 1.5% over the full three years which is equivalent to a 0.5% chance of failure over each of the individual three years.
- 2.18 So the lowest level of confidence that is permitted as standard by the FSA for a non-life company in run-off is a 97.5% level of confidence that the company has sufficient assets to

meet all of its liabilities over the full period until its last liability has been met. This level of confidence applies when the mean term of liabilities is greater than five years.

- 2.19 As a matter of established policy and to facilitate Part VII transfers, the FSA does not insist on equivalent (or increased) security levels for each set of policyholders post-transfer (compared to the pre-transfer position). In my opinion, in the absence of other reasons for objecting, the FSA is unlikely to object to a scheme if it concludes that the scheme has no material adverse effect on policyholders' security.
- 2.20 In my Previous Reports I confirmed that the likelihood of Transfercom being able to pay all future claims once the Proposed Scheme has been effected was 97.5%. I confirm that my conclusion on this point is unchanged. Given the mean payment term of Transfercom's liabilities after the Proposed Scheme (which is greater than 5 years) this level of security is satisfactory in my view. (In my view this is equivalent to a 99.5% confidence level over a one-year time horizon.)
- 2.21 As regards the position of transferring policyholders, however, as explained in Section AC.17 of Appendix C, this is a conservative assessment as it does not take into account the relative advantage that transferring policyholders have when compared to the existing Transfercom policyholders as a result of the different mean terms of Transfercom's liabilities to these two groups of policyholders: put simply, on average Transfercom will pay claims to transferring policyholders many years before it pays claims to its existing policyholders, which means the risk of a Transfercom insolvency is less for transferring policyholders than it is for existing Transfercom policyholders.
- 2.22 As some objectors have expressed concern about the difference between security in excess of 99.5% over one year to security of at least 97.5% on a run-off to ultimate basis, I set out below the Post Scheme position of transferring policyholders and existing Transfercom policyholders on a run-off to ultimate basis, using the results of some further modelling which takes into account the different mean terms of Transfercom's liabilities to the two groups of policyholders.
- 2.23 The transferring policyholders are moving from a large, well diversified and strongly capitalised company, with a AA- security rating from Standard & Poor's. The FSA's ICA solvency criterion of 99.5% over a one year time horizon is normally taken as approximating to a BBB rating. In fact, the Standard & Poor's report "Default, Transition, and Recovery: 2009 Annual Global Corporate Default Study And Rating Transitions" (the "S&P 2009 Default Study") shows the one year Global Corporate Average Default Rate for entities rated BBB as 0.24% (implying a 99.76% security level, rather than the 99.5% of the FSA). The equivalent Standard & Poor's figure for a company rated AA- is 0.04% implying a confidence level over a one year time horizon of 99.96%. Over a two year period the figure is 0.12% implying a security level of 99.88%; so allowing for the fact that the mean term of the liabilities of the transferring business is around two years, its security level within Sompo would be 99.88%.
- 2.24 Considering the security of the transferring business over its mean term of two years, and combining my selected distributions for the transferring business and the existing business within Transfercom (as set out in Sections AC.19 to AC.37 in Appendix C), together with my chosen correlation, investment income and credit risk assumptions (as set out in Appendix C), my updated model estimates that the likelihood of Transfercom being able to

pay all future claims on the transferring business after the Proposed Scheme has been effected is 99.6%.

- 2.25 Based on my analysis, I therefore consider that the level of security for the transferring policyholders will reduce from 99.88% to 99.6% on a run-off to ultimate basis if the Proposed Scheme is approved. However, I believe that the level of security of the transferring policyholders would remain satisfactory in that the probability of Transfercom being able to pay all future claims to the transferring policyholders after the Proposed Scheme would be 99.6% on a run-off to ultimate basis. As the mean term of the liabilities of the transferring business is around two years the considerations set out in Sections 2.13 to 2.15 above would imply that the required run-off to ultimate security level under the FSA's ICA regime for this book of business would be 99%.

Security of current policyholders of Transfercom

- 2.26 If the Proposed Scheme does not go ahead, my modelling, with the additional changes set out in Section 2.9 above, estimates that the likelihood of the existing assets within Transfercom being sufficient to pay all claims from the existing business within Transfercom is 95.2%. This is an increase from the assessment in my Independent Expert Report, since the increase in security as a result of making an explicit allowance for future investment income slightly outweighs the reduction in security as a result of making an explicit allowance for credit risk.
- 2.27 In conjunction with the Proposed Scheme the limit of the reinsurance with NICO which protects the current business of Transfercom will increase by US\$100 million. At the time of finalising my Independent Expert Report the limit of this reinsurance with NICO was due to be increased by US\$75 million and at the time of finalising my Supplemental Report the limit of this reinsurance was due to be increased by US\$80 million.
- 2.28 The benefit of this increase in reinsurance is offset, but only to a limited extent, by the following:
- an increase in the counterparty credit risk in respect of the increase in the reinsurance arrangements with NICO;
 - the possibility of the transferring business exceeding its applicable reinsurance protection, and accessing, or possibly exhausting, the free capital in Transfercom; and
 - the potential erosion of Transfercom's capital due to the operation of the new Funds Withheld Endorsement under the reinsurance policy protecting the transferring business (see Section 3.88 below).
- 2.29 The second offsetting factor has reduced significantly in impact since my Previous Reports given the significant improvements in the reserving position of the transferring business, as set out in Sections AC.19 to AC.26 of Appendix C.
- 2.30 I have estimated that the likelihood of Transfercom being able to pay all future claims from the existing business of Transfercom after the Proposed Scheme has been effected is effectively unchanged from my previous assessment at 97.5%.

- 2.31 Compared to my previous assessment the improvement in security from the allowance for future investment income, the increased net assets of Transfercom (from existing investment income) and from the improved reserving position of the transferring book is almost exactly offset on a Post Scheme position by the counterparty risk of the reinsurance covers and of the bond held by Transfercom.
- 2.32 The Post Scheme position represents a significant improvement in security for the current policyholders of Transfercom compared to the Pre Scheme position and therefore I believe that the current policyholders of Transfercom will be advantaged by the Proposed Scheme. In addition the resulting security level is, given the mean term of payment (of greater than 10 years) of the existing policyholders, satisfactory in my view. (In my view this is equivalent to a 99.5% confidence level over a one-year time horizon.)

Other considerations for all three groups of policyholders

- 2.33 With respect to other potential considerations, I am not aware of any new pieces of information which are relevant to these considerations and which have become available since the completion of my Supplemental Report.
- 2.34 I therefore consider that the conclusions set out in Sections 2.13, 2.14 and 2.15 of my Independent Expert Report remain applicable and my opinions on these points remain unchanged.

Duty to the Court

- 2.35 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.

Statement of truth

- 2.36 I confirm that insofar as the facts stated in my report are within my own knowledge I have made clear which they are and I believe them to be true, and that the opinions I have expressed represent my true and complete professional opinion.



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Section 3: Responses to objections raised by Riverstone

Introduction

- 3.1 In this section I set out my comments, and responses to, the objections raised by Riverstone. To aid the reader, I have repeated the specific objections raised by Riverstone in *orange italics* below (including repeating the numbering used by Riverstone). My comments and responses follow thereafter in black.
- 3.2 I have only provided comments and responses to those objections which I believe relate to matters within my expertise. Further, in accordance with the instructions I received in the Instruction Letters from Lovells, I have not addressed issues raised by Riverstone which relate to requests for documentation or underlying data.

Responses to objections raised by Riverstone

Riverstone Management Limited (“RSML”) and Riverstone Insurance (UK) Limited (“RIUK”) (together “Riverstone”) have previously expressed their concerns regarding the proposed transfer in correspondence between Reynolds Porter Chamberlain LLP (“RPC”) and Lovells, most recently in RPC’s letter of 24 March 2010. Since that letter some further information, being the documentation filed at court for the directions hearing on 29 January 2010, has been made available. Below we set out a summary of Riverstone’s current concerns in relation to the transfer. Riverstone reserves its rights to raise additional issues in the future as more information is received.

It is particularly to be noted that the documents before the court contain material redactions. It is hoped that unredacted documents will be made available to Riverstone and the court, so that proper consideration can be given to the Scheme and its implications for persons in the position of Riverstone.

- 3.3 This objection relates to a disclosure matter. In my view such matters are not within the scope of my role as Independent Expert and in accordance with my instructions (as included in Appendix B) will not be addressed in this report.

One significant item of information which has been withheld is the premium to be paid by Sompo to Transfercom and by Transfercom to National Indemnity Co. Without this information it is impossible to understand the commercial logic of the scheme. Given that the bulk of the business to be transferred is now very short-tail, especially in view of the recent subrogation settlement of WTC claims, a premium at anything materially less than the amount for which the business is reserved suggests that Transfercom would have an economic motivation to delay the payment of claims; while a premium at materially more suggests that from Sompo’s perspective the business is underreserved. Whether the Independent Expert was told the amount of the premium is not clear (eg paragraphs 3.18 and 5.8 of his Report): if he was, he has avoided any mention of the amount, despite the importance of this information for anyone attempting to understand the scheme and its implications for the protagonists and their creditors.

- 3.4 As part of the work underlying my Independent Expert Report (as set out in Section 3.9 of that report) I did not carry out any specific work to consider the reasonableness (or otherwise) of the premium to be paid by Sompo to Transfercom. Rather I allowed for the protection provided by the proposed reinsurance policy (and the premium paid) as one of the elements in considering the effect of the Proposed Scheme (in its totality) on the different sets of policyholders.
- 3.5 I was notified of the premium to be paid in respect of the reinsurance contract. However it was considered a commercially sensitive figure by Sompo and therefore I did not disclose the amount in my Independent Expert Report. In response to Riverstone's two concerns as repeated above; in my opinion the amount of the premium does not have either of the implications i.e. to either give Transfercom an economic motivation to delay the payment of the claims or to suggest that Sompo is under-reserved.

1. *Reserving*

- 1.1 *Riverstone is concerned that the level of security provided by Transfercom is inadequate.*
- 1.2 *No explanation is contained in the Independent Expert's reports or any other documents made available of the reserving policy applied by Sompo or Transfercom for claims generally and particularly in relation to the events of 11 September 2001 ("WTC"). For example, it is possible that claims which RIUK and others in a similar position have against Sompo in respect of WTC claims may have been reserved on the basis of one event and loss rather than two (one for each of the two towers in the WTC).*
- 1.3 *Not only is it is [sic] unclear whether Sompo has reserved for WTC as one or several events, but it is also unclear whether the reserves to be transferred to Transfercom will be transferred on the same basis. It is believed that WTC losses form 80-90% of the transferring book of business so the impact of this could be significant under-reserving. Riverstone's lack of confidence is further exacerbated by the fact that a recent settlement of losses by Sompo, which included WTC losses, was made under a strict reservation of rights put forward by Sompo only at the last minute, but it was also suggested that in some way the reservation of rights in Transfercom might be different. In other words it would seem to have been envisaged that Transfercom would have a right of recovery in respect of the amount paid by Sompo, and that the right might be available in different circumstances.*
- 1.4 *There remains continued uncertainty over the development of the WTC reserves. There is current uncertainty, possible future litigation and potential for further latent claims (e.g. respiratory claims) which all make the remaining significant reserves volatile. This is a concern for Riverstone, in particular as RIUK has exposure to WTC claims reinsured into Sompo which may not be resolved by the property subrogation settlement. No explanation has been provided as to how the Independent Expert has accounted for these possibilities. Nor is it clear what is the basis for his acceptance of the conclusion by PwC (at page 21 of his main report) that there is negative IBNR and related items of some \$25m (implying – optimistically, given uncertainty over the development of ongoing litigation despite the recent subrogation settlement - a saving on existing case reserves, notwithstanding any required IBNR).*
- 3.6 As set out in Sections 4.35 and 4.36 of my Independent Expert Report, I requested and received detailed additional information to enable me to consider the uncertainty around the development of the transferring business. This work included detailed consideration of the uncertainty surrounding the claims relating to 11 September 2001, including those specifically relating to World Trade Center claims.

- 3.7 As noted in the first bullet of Section 4.36 of my Independent Expert Report, the case reserving and PricewaterhouseCoopers' ("PwC's") IBNR reserving approach is conservative and in many cases takes a worst case or at least pessimistic view of the possible outcomes on individual claims or legal issues. In respect of the case reserving and PwC's IBNR reserving approach, I have been supplied with all of the information I have requested and answers to all the questions I have raised have been provided, however the details of this reserving were considered confidential by Sompo and were therefore not disclosed in my Independent Expert Report.
- 3.8 I am however able to give some additional information in this report. In broad terms the approach taken by Sompo to reserving has been to reserve all aviation losses in respect of World Trade Center losses on the basis which is most advantageous for each individual cedant. In particular and in relation to Riverstone's specific point in 1.2., where a cedant has presented losses on a two loss basis this basis is used for Sompo's reserving. Where a cedant has advised the World Trade Center as a single loss but Sompo's analysis is that, in simple terms, that it may be in the cedant's interests to present losses on a two loss basis, Sompo reserve on a two loss basis.
- 3.9 In addition to this in my analysis of the uncertainty of the reserving position I have included in my assessment the possibility that all cedants' WTC losses are ultimately paid on a two loss basis even when this may reduce the cedant's overall reinsurance recoveries but would (owing to the way in which Sompo's reinsurance of the cedant attaches) increase the claims to Sompo.
- 3.10 In respect of the specific query raised by Riverstone around my acceptance of PwC's conclusion, I have reproduced below the table on page 21 of my Independent Expert Report which summarises the reserve estimates in PwC's report as at 31 March 2009.

All figures in US\$ millions

Case reserves for losses and LAE	239.3
IBNR & related amounts	
Reserve for IBNR losses and LAE	22.5
Additional premiums relating to case reserves and IBNR	- 57.1
Profit commissions	9.9
	- 24.7
Expected recoveries from Taisei Re on fronted contracts	- 3.6
TOTAL CASE RESERVES PLUS IBNR & RELATED AMOUNTS	211.0
Unpaid paid loss amounts	
Unpaid paid losses	39.7
Additional premiums relating to unpaid paid losses	- 14.0
Unpaid paid profit commissions	0.3
	26.1
TOTAL CASE RESERVES, IBNR & RELATED AMOUNTS AND UNPAID PAID LOSS AMOUNTS	237.1

- 3.11 The third row of the above table shows an IBNR reserve of (a positive amount of) US\$22.5 million, so that PwC's reserve figures do assume a deterioration in existing case reserves.
- 3.12 The IBNR and related items is shown in the sixth row of the above table and totals negative US\$24.7 million. This is the figure which Riverstone are querying.
- 3.13 This figure includes a negative item of US\$57.1 million relating to "Additional premiums relating to case reserves and IBNR" (italics added for emphasis). As I commented in Section 4.26 of my Independent Expert Report this amount is predominantly in respect of additional reinstatement premiums relating to outstanding claims (rather than IBNR). I understand that it is practice in the aviation reinsurance market for reinstatement premiums to be netted off against any outstanding claims or IBNR paid and I have therefore not allowed for any counterparty risk in respect of these amounts.
- 3.14 In respect of purely IBNR losses the associated additional premiums (which are not distinguished in the above table) are significantly less than the IBNR reserve so that PwC's reserve figures do assume a deterioration in existing case reserves net of additional premiums.
- 1.5 *Further, the PwC report relied upon by the Independent Expert pre-dated the subrogation settlement and is therefore out of date. We would suggest that separate independent report be commissioned from someone with the requisite experience specifically to deal with the worst case outcomes of all WTC related claims and litigation on the transferring business. But in any event the PwC report should be made available to Riverstone, as this is a fundamental building block supporting the Independent Expert's assessment of the Scheme.*
- 3.15 PwC's review on which I placed my reliance had an effective date of 31 March 2009. I have carried out a detailed investigation into the development of the reserves in respect of the transferring business in the 12 months from 31 March 2009 to 31 March 2010, together with all claims movements in April 2010. This investigation has been based on analysis of detailed schedules of movements in paid claims, case reserves and IBNR reserves. These schedules were supplemented by further cedant-specific narratives from Resolute Management Limited ("Resolute") to assist me to understand these movements and to understand their implications both for current reserves and reserve uncertainty of (inter alia):
- The proposed subrogation settlements between the property and aviation insurers in respect of the World Trade Center claims (to which Riverstone refers). In February 2010 various Aviation defendants (American Airlines, United Airlines, Burns Security and ITCS Huntleigh) reached agreement with various Property Plaintiffs for a settlement of US\$1.20 billion. This settlement was approved by Judge Hellerstein on 27 May 2010 and will be finalised when he issues his full findings and conclusions.
 - The potential for respiratory claims in respect of the World Trade Center
 - A number of disputes in which Sompo is or has been involved including a recent arbitration award
 - Asbestos exposures on older years of business

- Developments on other major claims events
- 3.16 During the period 1 April 2009 to 21 April 2010, the booked claims position (i.e. the claims position in Sompo's account) has fallen by US\$71.3 million with claims paid during the same period being US\$62.5 million. These figures are net of additional premiums. The full details behind this position are set out in Sections AC.20 to AC.21 in Appendix C of this report.
- 3.17 The results of my more detailed investigation described in Section 3.15 are that the most significant developments in either individual or groups of claims or legal disputes and arbitrations directly involving Sompo have led to an improvement in the current claims position of Sompo compared to the position in the PwC report at 31 March 2009. However this improvement has not always been reflected in the booked position as the ultimate claims position has historically only been altered in response to a PwC reserve review. As Sompo agreed to transfer the business to Transfercom during 2009, it did not commission a further annual IBNR review from PwC. As a result the ultimate claims position has been rolled forward so that it is largely fixed at the 31 March 2009 position.
- 3.18 The results of my investigation are that, while there have been some developments in either individual or groups of claims which have led to deteriorations in booked reserves, overall the developments represent a material improvement in total case reserves and IBNR of US\$17.2 million which is not reflected in the booked position.
- 3.19 This would indicate that the overall position of the transferring business has improved over the period and that the booked reserves as at 21 April 2010 represent a significantly more conservative view of ultimate claims than the booked reserves as at 31 March 2009. In turn this means that there is a significant increase to the difference between the limit of the NICO reinsurance cover and the best estimate of the transferring reserves.
- 3.20 As well as improving the reserving position, these developments also lend weight to the view repeated in Section 3.7 above.
- 3.21 In addition, a number of the developments have impacted the certainty of the reserving position and overall have reduced the uncertainty around the ultimate claims position of the transferring book. The effect of this, combined with the conclusion in Section 3.19 is to significantly decrease the likelihood that the limits of the NICO reinsurance protection in respect of the transferring book will be breached. The developments in both the reserving position, and the certainty around this position, have both been reflected in my revised assessment which is described starting at Section 3.28.
- 1.6 *There is no apparent independent assessment of Transfercom's current reserves. The Wilson report is based on 4Q 2008 data and thus is out of date; but it was not in any event commissioned as an independent report for the purposes of such a scheme as the present. The White report was produced by a company related to Transfercom. The Independent Expert does not state what independent evaluation of Transfercom's reserves exists and/or what evaluation he has performed of the reserves.*
- 3.22 In compiling my Independent Expert Report I placed reliance on the Wilson Report but stated that I was awaiting the results of the White Report and that I would base my Supplemental Report on the White Report (see Sections 4.48 and 4.49 of my Independent

Expert Report). For my Supplemental Report I therefore relied on the White Report to assess the reserve uncertainty on the current business within Transfercom.

- 3.23 UK actuarial guidance for general insurance reports is set out in GN12 which states that “If a member has relied upon the knowledge of another suitably qualified Actuarial professional then this must be made clear in the report”.
- 3.24 Additionally the FSA’s guidance on Transfers of Business (SUP 18) sets out the specific requirements for an Independent Expert’s report in Sections 18.2.31 to 18.2.41. Section 18.2.33 sets out the information that the report should contain and states that the report should include the following information:

“(9) *the extent to which the independent expert has relied on*

(a) information provided by others; and

(b) the judgement of others;

(10) the people on whom the independent expert has relied and why, in his opinion, such reliance is reasonable”

- 3.25 This guidance makes it clear that the independent expert may rely on the judgement of others providing that, in the independent expert’s opinion, such reliance is reasonable. There are no conditions that the third parties so involved should themselves be independent of the transferor and transferee. In my experience it is common practice for independent experts to, for example, place reliance on capital assessments performed by the transferor and transferee companies even when such reviews have not been subject to any form of independent sign-off.
- 3.26 As stated at Section 3.17 of my Supplemental Report I satisfied myself from my detailed review of the White Report and my discussions with Martin White that the report was reliable and both fit and fully adequate for my purpose (i.e. for me to place reliance on).
- 3.27 My key reasons for this conclusion were that:
- In my opinion Martin White is an expert in the area of London market run-off reserving (and in particular reserving for asbestos exposures) from his many years of experience as reserving actuary for Equitas.
 - Based on our experience of benchmark survival and IBNR/case ratios used by companies with US asbestos and environmental pollution/health hazard claims (which dominate the other losses in the current business of Transfercom) the benchmarks used by Martin White for his best estimate analysis (and the implicit benchmarks underlying the tail end of the distribution) are at the high end of a typical range of such factors and therefore represent a conservative approach.

1.7 As part of his analysis, the Independent Expert has off set the liquidity and credit risks against the expected investment return. Given that the reserves could substantially crystallise in the near future as a result of claims settlements this would not seem appropriate. The Independent Expert should have evaluated each element individually.

3.28 In response to the queries raised in this area by the various objectors I have carried out a more detailed analysis of these risks.

3.29 For the analysis which supported my Previous Reports:

- I made no specific allowance for the investment return to be earned on the capital levels of Transfercom during the run-off of claims, as I assumed that this was counterbalanced by also not considering the counterparty credit risk in respect of NICO and the liquidity and credit risk in respect of the US\$30 million bond holding. In my view this was a reasonable assumption.
- I treated the security levels of both books of business as identical and did not consider their very different payment profiles. This simplification represented a conservative view of security levels for the transferring policyholders and had no material impact on my assessment of security levels for the existing policyholders of Transfercom.

3.30 A number of the objections received have centred around two issues:

- A requirement for an explicit treatment of investment returns, counterparty credit risk and liquidity risk
- A requirement to understand in more detail the security level of the transferring policyholders and the time frame over which the assessment of this level is made.

3.31 In response to the objections raised I have updated my modelling approach in three main ways:

- First to alter the modelling assumptions to give explicit consideration to investment income and counterparty credit risk (and to discuss in more detail liquidity risk). This is described further in Sections AC.10 to AC.16 in Appendix C.
- Secondly to present the results of the model to make allowance for the different expected future payment periods of the two sets of policyholders, as described further in Sections AC.17 and AC.18 in Appendix C.
- Finally I have updated my assessment of reserve uncertainty for developments since the effective date of my Previous Reports. In light of the requirements of the updated approach and presentation this has included the need to allow for the payment pattern of the two sets of reserves (for the transferring and current business). This assessment is set out in Sections AC.19 to AC.40 in Appendix C.

3.32 A summary of the results of my updated analysis is set out below.

Security of policyholders transferring from Sompo to Transfercom – conclusion

3.33 My assessment of the Post Scheme security of the transferring policyholders (and of the existing Transfercom policyholders) was based around the level of policyholder protection required for FSA authorised companies under the ICA regime. Under this regime, security has to be at least equal to a 99.5% confidence level over a one-year timeframe that the

value of assets of the company will exceed the value of liabilities. This implies a 0.5% chance of failure in that the value of the liabilities do not meet the value of the assets after one year.

- 3.34 FSA guidance is that companies can select a longer time horizon than one year for this assessment, in which case the percentage confidence level does not have to be as high, as it relates to a longer period. A longer time horizon is particularly common for non-life firms in run-off where the typical approach is to use a time horizon over the entire outstanding duration of the business; so an assessment is made of whether the company will meet all of its liabilities over the full period until its last liability has been met. I will sometimes refer to this as a confidence level “on a run-off to ultimate” basis in this report.
- 3.35 Under this “run-off to ultimate” approach the standard rule of thumb when setting the required confidence level percentage is to reduce the 99.5% confidence level over a one-year timeframe by 0.5% for each year that the mean outstanding term of liabilities is greater than one, up to a maximum of five years.
- 3.36 Hence, acceptable security levels are as shown in the table below.

<i>Mean outstanding term of liabilities</i>	<i>Confidence level</i>	<i>Chance of failure</i>
1	99.50%	0.50%
2	99.00%	1.00%
3	98.50%	1.50%
4	98.00%	2.00%
5 or greater	97.50%	2.50%

- 3.37 Taking the example of a book of business with a mean outstanding term of three years, the acceptable chance of failure under the FSA’s ICA regime is 1.5% over the full three years which is equivalent to a 0.5% chance of failure over each of the individual three years.
- 3.38 So the lowest level of confidence that is permitted as standard by the FSA for a non-life company in run-off is a 97.5% level of confidence that the company has sufficient assets to meet all of its liabilities over the full period until its last liability has been met. This level of confidence applies when the mean term of liabilities is greater than five years.
- 3.39 As a matter of established policy and to facilitate Part VII transfers, the FSA does not insist on equivalent (or increased) security levels for each set of policyholders post-transfer (compared to the pre-transfer position). In my opinion, in the absence of other reasons for objecting, the FSA is unlikely to object to a scheme if it concludes that the scheme has no material adverse effect on policyholders’ security.
- 3.40 In my Previous Reports I confirmed that the likelihood of Transfercom being able to pay all future claims once the Proposed Scheme has been effected was 97.5%. I confirm that my conclusion on this point is unchanged. Given the mean payment term of Transfercom’s liabilities after the Proposed Scheme (which is greater than 5 years) this level of security is

satisfactory in my view. (In my view this is equivalent to a 99.5% confidence level over a one-year time horizon.)

- 3.41 As regards the position of transferring policyholders, however, as explained in Section AC.17 of Appendix C, this is a conservative assessment as it does not take into account the relative advantage that transferring policyholders have when compared to the existing Transfercom policyholders as a result of the different mean terms of Transfercom's liabilities to these two groups of policyholders: put simply, on average Transfercom will pay claims to transferring policyholders many years before it pays claims to its existing policyholders, which means the risk of a Transfercom insolvency is less for transferring policyholders than it is for existing Transfercom policyholders. This is also true on an incurred basis (i.e. allowing for insolvency on the basis that the future best estimate of claims are projected to exhaust reinsurance protections and the available capital of Transfercom) as the relative payment terms means that the transferring policyholders' claims are likely to be settled before the full reserving uncertainty on the existing business potentially emerges.
- 3.42 As some objectors have expressed concern about the difference between security in excess of 99.5% over one year to security of at least 97.5% on a run-off to ultimate basis, I set out below the Post Scheme position of transferring policyholders and existing Transfercom policyholders on a run-off to ultimate basis, using the results of some further modelling which takes into account the different mean terms of Transfercom's liabilities to the two groups of policyholders.
- 3.43 The transferring policyholders are moving from a large, well diversified and strongly capitalised company, with a AA- security rating from Standard & Poor's. The FSA's ICA solvency criterion of 99.5% over a one year time horizon is normally taken as approximating to a BBB rating. In fact, the Standard & Poor's report "Default, Transition, and Recovery: 2009 Annual Global Corporate Default Study And Rating Transitions" (the "S&P 2009 Default Study") shows the one year Global Corporate Average Default Rate for entities rated BBB as 0.24% (implying a 99.76% security level, rather than the 99.5% of the FSA). The equivalent Standard & Poor's figure for a company rated AA- is 0.04% implying a confidence level over a one year time horizon of 99.96%. Over a two year period the figure is 0.12% implying a security level of 99.88%; so allowing for the fact that the mean term of the liabilities of the transferring business is around two years, its security level within Sompo would be 99.88%.
- 3.44 Considering the security of the transferring business over its mean term of two years, and combining my selected distributions for the transferring business and the existing business within Transfercom (as set out in Sections AC.19 to AC.37 in Appendix C), together with my chosen correlation, investment income and credit risk assumptions (as set out in Appendix C), my updated model estimates that the likelihood of Transfercom being able to pay all future claims on the transferring business after the Proposed Scheme has been effected is 99.6%.
- 3.45 Based on my analysis, I therefore consider that the level of security for the transferring policyholders will reduce from 99.88% to 99.6% on a run-off to ultimate basis if the Proposed Scheme is approved. However, I believe that the level of security of the transferring policyholders would remain satisfactory in that the probability of Transfercom being able to pay all future claims to the transferring policyholders after the Proposed Scheme would be 99.6% on a run-off to ultimate basis. As the mean term of the liabilities

of the transferring business is around two years the considerations set out in Sections 3.33 to 3.35 above would imply that the required run-off to ultimate security level under the FSA's ICA regime for this book of business would be 99%.

Security of current policyholders of Transfercom – conclusion

- 3.46 If the Proposed Scheme does not go ahead, my modelling, with the additional changes set out in Section 3.31 above, estimates that the likelihood of the existing assets within Transfercom being sufficient to pay all claims from the existing business within Transfercom is 95.2%. This is an increase from the assessment in my Independent Expert Report, since the increase in security as a result of making an explicit allowance for future investment income slightly outweighs the reduction in security as a result of making an explicit allowance for credit risk.
- 3.47 In conjunction with the Proposed Scheme the limit of the reinsurance with NICO which protects the current business of Transfercom will increase by US\$100 million. At the time of finalising my Independent Expert Report the limit of this reinsurance with NICO was due to be increased by US\$75 million and at the time of finalising my Supplemental Report the limit of this reinsurance was due to be increased by US\$80 million.
- 3.48 The benefit of this increase in reinsurance is offset, but only to a limited extent, by the following:
- an increase in the counterparty credit risk in respect of the increase in the reinsurance arrangements with NICO;
 - the possibility of the transferring business exceeding its applicable reinsurance protection, and accessing, or possibly exhausting, the free capital in Transfercom; and
 - the potential erosion of Transfercom's capital due to the operation of the new Funds Withheld Endorsement under the reinsurance policy protecting the transferring business (see Section 3.88 below).
- 3.49 The second offsetting factor has reduced significantly in impact since my Previous Reports given the significant improvements in the reserving position of the transferring business, as set out in Sections AC.19 to AC.26 of Appendix C.
- 3.50 I have estimated that the likelihood of Transfercom being able to pay all future claims from the existing business of Transfercom after the Proposed Scheme has been effected is effectively unchanged from my previous assessment at 97.5%.
- 3.51 Compared to my previous assessment the improvement in security from the allowance for future investment income, the increased net assets of Transfercom (from existing investment income) and from the improved reserving position of the transferring book is almost exactly offset on a Post Scheme position by the counterparty risk of the reinsurance covers and of the bond held by Transfercom.
- 3.52 The Post Scheme position represents a significant improvement in security for the current policyholders of Transfercom compared to the Pre Scheme position and therefore I believe

that the current policyholders of Transfercom will be advantaged by the Proposed Scheme. In addition the resulting security level is, given the mean term of payment (of greater than 10 years) of the existing policyholders, satisfactory in my view. (In my view this is equivalent to a 99.5% confidence level over a one-year time horizon.)

- 1.8 *The analysis of latent claims exposure in the transferring book appears inadequate. Sompo was a Fortress Re member from 1982 (and could have picked up earlier years) and so could be exposed to long tail claims. There is no reference to any such claims which have been advised to date. In addition, it appears that the Independent Expert has solely relied on the PwC report to assess future exposure, but has not provided necessary details of the analysis undertaken.*
- 3.53 The last bullet point in Section 4.36 of my Independent Expert Report referred to the issue of latent claims. I have however provided more detail in this report in light of the specific questions raised by Riverstone and other objectors.
- 3.54 Typically, aviation exposure to asbestos losses has affected contracts written in the 1960s and 1970s, with the removal of Aggregate Extension Clauses from aviation excess of loss contracts largely excluding such losses after the mid 1980s. In my experience it was the existence of these clauses that has largely caused asbestos losses to be paid from aviation excess of loss contracts, since they permitted the aggregating of what would otherwise be two or more occurrences so that they are considered as one occurrence for the purposes of excess of loss reinsurance contracts, and hence becoming more likely to exceed the excess in place for such contracts. Further, from the end of 1985 I understand that asbestos exclusion clauses were generally included in the direct insurances which the Fortress Re Pool was reinsuring and as I have explained the reinsurance contracts to which Fortress Re subscribed did not generally contain aggregate extension clauses. Aggregate asbestos losses could not therefore generally be passed on to Sompo under contracts entered into after 1985. I have been informed by Resolute that no aggregate asbestos losses have been notified under contracts entered into after that date.
- 3.55 The operation of the Fortress Re Pool was such that there were no portfolio transfers between years with each year running off to expiry. Sompo first joined the pool for the year commencing 1 July 1981 and hence cannot have exposure to business written before 1 July 1981. In addition, Sompo's share of the Fortress Re Pool was much lower for the first four years of its participation in the pool (between 7.14% and 8.33%), before increasing to 20% from the 1 July 1985 year, 24% for the 1 July 1992 year and then 26% for the remainder of the years which Sompo participated in the pool.
- 3.56 Sompo has had some incidental aggregate asbestos exposures from London market excess of loss contracts written by the Fortress Re Pool in 1984 and 1985, however the amount of such claims booked is only US\$176,250 and the remaining cover on contracts where claims have been made is in total less than US\$150,000. The majority of the marine and non-marine cover written in 1984 and 1985 by the Fortress Re Pool was catastrophe type cover and would not be exposed to US casualty losses including asbestos claims.
- 3.57 For the reasons set out in Sections 3.54 to 3.56 above I consider that my comment in Section 4.36 of my Independent Expert Report that "given the occurrence liability nature of the book there is a possibility of some form of latent claims development, although I would place this probability in the extreme tail of the distribution" was entirely reasonable.

3.58 I have commented in Sections 3.23 to 3.25 above on the issue of placing reliance on the work or judgement of others. Sections 4.21 to 4.24 of my Independent Expert Report set out my reasons for feeling that such reliance was appropriate. The PwC report was in my view entirely adequate for the purposes for which it was originally commissioned by Sompo. However, in Section 4.35 of that report I comment on the one area where I felt that the PwC report was not entirely adequate for my purposes. In Sections 4.35 to 4.37 of that report I have commented on the additional information I requested and received which allowed me to gain a full understanding of the reserving issues around uncertainty.

2. Liquidity

2.1 *The transfer will result in a significant change to the level of security currently enjoyed by Riverstone and other Sompo policyholders.*

2.2 *The effect of the transfer from Sompo to Transfercom is to change Riverstone's counterparty under its contracts of reinsurance from one which has a security level significantly greater than a 1 in 200 chance of being unable to meet its liabilities to policyholders (paragraph 4.13 of the Independent Expert's report) to one which has a 1 in 40 chance (99.5% to 97.5%). The Independent Expert has not explained his calculation of these outcomes and why the change is acceptable. However, the Independent Expert notes that if the transfer does not go ahead, the likelihood of Transfercom being able to meet its liabilities to policyholders is only 93.8%. The implication of this statement is that the economic effect of the transfer is to reduce the security of the transferring policyholders while improving the security of the existing Transfercom policyholders. Surely this suggests that from the perspective of transferring policyholders such as Riverstone the scheme is not equitable, materially disadvantaging them for the benefit of other policyholders and the convenience or profit of Sompo and Transfercom?*

3.59 My assessment of the security level in Sompo was set out in Sections 4.12 and 4.13 of my Independent Expert Report and was based around a high level assessment of Sompo as a very strongly capitalised group with a strong security rating.

3.60 The basis of the detailed calculations I performed to assess the likelihood of Transfercom being able to pay all future claims after the Proposed Scheme of 97.5% is set out in Sections 4.21 to 4.54 of my Independent Expert Report and Sections 3.15 to 3.29 of my Supplemental Report.

3.61 The specific conclusions for the security of the transferring policyholders are set out in Sections 4.56 to 4.60 of my Independent Expert Report and Sections 3.34 to 3.38 of my Supplemental Report. In both cases I made it clear that the Proposed Scheme will reduce the security of the transferring policyholders but that I considered the level of security after the Proposed Scheme to be satisfactory.

3.62 This assessment was based around the level of policyholder protection required for FSA authorised companies under the ICA regime, which has to be an assessment at least equal to a 99.5% confidence level over a one-year timeframe that the value of assets of the company will exceed the value of liabilities. This implies a 0.5% chance of failure in that the value of the liabilities do not meet the value of the assets after one year.

3.63 FSA guidance is that companies can select a longer time horizon than one year for this assessment and a lower confidence level to reflect the longer time horizon. Such an assessment is particularly common for non-life firms in run-off where the typical approach

is to use a time horizon over the entire outstanding duration of the business; so an assessment is made of whether the company will meet all of its liabilities over the full period until its last liability has been met. I will sometimes refer to this as a confidence level “on a run-off to ultimate” basis in this report.

3.64 Under this “run-off to ultimate” approach the standard rule of thumb when setting the required confidence level percentage is to reduce the 99.5% confidence level over a one-year timeframe by 0.5% for each year that the mean outstanding term of liabilities is greater than one, up to a maximum of five years.

3.65 Hence, acceptable security levels are as shown in the table below.

<i>Mean outstanding term of liabilities</i>	<i>Confidence level</i>	<i>Chance of failure</i>
1	99.50%	0.50%
2	99.00%	1.00%
3	98.50%	1.50%
4	98.00%	2.00%
5 or greater	97.50%	2.50%

3.66 Taking the example of a book of business with a mean outstanding term of three years, the acceptable chance of failure under the FSA’s ICA regime is 1.5% over the full three years which is equivalent to a 0.5% chance of failure over each of the individual three years.

3.67 So the lowest level of confidence that is permitted as standard by the FSA for a non-life company in run-off is a 97.5% level of confidence that the company has sufficient assets to meet all of its liabilities over the full period until its last liability has been met. This level of confidence applies when the mean term of liabilities is greater than five years.

3.68 As a matter of established policy and to facilitate Part VII transfers, the FSA does not insist on equivalent (or increased) security levels for each set of policyholders post-transfer (compared to the pre-transfer position). In my opinion, in the absence of other reasons for objecting, the FSA is unlikely to object to a scheme if it concludes that the scheme has no material adverse effect on policyholders’ security.

3.69 For the transferring business of itself I estimated (see Section 4.57 of my Independent Expert Report and Section 3.35 of my Supplemental Report) that the reinsurance arrangement put in place to protect that business had a 99.5% chance of meeting all of the claims from that business (even without recourse to the capital of Transfercom).

3.70 However, as set out in Section 4.58 of my Independent Expert Report and Section 3.36 of my Supplemental Report, there remains a risk to the transferring business that the claims on the existing business exhaust the applicable (and extended) reinsurance cover for that business and the capital levels of Transfercom. In practice the extremely long mean term of the existing business compared to the transferring business means that any such exhaustion would likely occur after all or most of the transferring claims have been paid. Nevertheless, to be conservative, I ignored the different mean terms of the existing and

transferring business when assessing the security level for the transferring policyholders and accordingly, for my Previous Reports, assessed the likelihood of Transfercom being able to pay all future claims for both the existing and transferring policyholders as 97.5%. In light of the considerations in Section 3.62 I regarded this as a satisfactory level of security.

- 3.71 In response to the queries raised by the various objectors, and to allow for changes in the development of the transferring business since the finalisation of my Previous Reports, I have, as described in Sections 3.28 to 3.31, built a more detailed capital model to assess the Post Scheme Position of the policyholders transferring from Sompo UK to Transfercom and the Pre and Post Scheme Position of the current policyholders of Transfercom. This approach is more detailed than in my Previous Reports in terms both of those risks (and income) modelled and an explicit allowance for the different mean terms of the two sets of policyholders. I have also compared in detail the equivalent levels of security to the equivalence criteria set out above.
- 3.72 The modelling approach I have followed, and the results of the analysis, are set out in detail in Appendix C.
- 2.3 *As at 31 March 2009, Sompo held investments and cash of \$45.3 billion. Of this, \$3.3 billion was in cash and short term investments which are readily available to meet liabilities. In contrast, Transfercom's total capital is \$45 million. Of this, \$37 million is in cash and investments, but \$30 million of that is in a 10 year fixed interest debt security (the "Bond") which it is intended will be held until maturity in 2018. Accordingly, there are limited available assets to meet liabilities.*
- 2.4 *The Independent Expert notes that the Bond has an NAIC SVO rating of 4, the equivalent to Standard & Poor's rating B. The Bond therefore appears to be below investment grade. It is not clear whether the Independent Expert has considered the rate at which bonds of this rating are subject to default and to what extent the investment income available from the Bond should be offset by the risk of default.*
- 3.73 I have considered the counterparty credit risk on this bond in my revised assessment which is described starting at Section 3.28 and set out in detail in Sections AC.13 to AC.16 of Appendix C.
- 2.5 *Liquidity will be strained by the anticipated settlement in the near future of further WTC losses.*
- 3.74 Sompo is already settling (or has settled), within current reserves, around US\$70 million of claims (gross of reinstatement premiums) in respect of the subrogation settlements between the property and aviation reinsurers in respect of claims relating to the World Trade Center event (see comments in Section 3.15).
- 3.75 The proposed reinsurance treaty to cover the transferring business provides for Transfercom to raise quarterly billings to NICO (in respect of both claims payments and expenses) which must be paid within 14 days. If aggregate claims exceed US\$1 million in any quarter then Transfercom has the option to request a mid-quarter billing which NICO is required to settle within 10 days.

- 3.76 The same clauses apply to the reinsurance contract covering the existing business and my understanding is that all such claims (including one instance of mid-quarter billing) have been settled in full and in a timely manner.
- 3.77 In addition, according to Transfercom's latest unaudited management accounts as at 31 March 2010, Transfercom has liquid funds of in excess of US\$15 million which are available and are used to settle mid-quarter claims.
- 3.78 Finally, an additional endorsement (which I refer to as the "Funds Withheld Endorsement") has been added to the proposed reinsurance contract with NICO to cover the transferring business (at the request of the FSA). Under this endorsement the premium for the contract will be retained by Transfercom in a separate account, the funds of which are available for Transfercom to pay claims or expenses arising from the transferring business. NICO has the ability to request:
- Payment to NICO of any part of the funds in the account in excess of 102% of the expected value of future claims and expenses in respect of the transferring business
 - Payment of all remaining funds into a Trust Fund established on terms acceptable to Transfercom with the funds in it held on trust for the benefit of Transfercom.
- 3.79 If the Trust Fund option is not exercised then this further increases liquidity levels which I already considered satisfactory based on paragraphs 3.74 to 3.77 above. If the Trust Fund option is exercised then the liquidity levels will essentially be as set out in 3.74 to 3.77 above.
- 2.6 The apparent reliance on reinsurance asset (especially from a single policy with a non-UK regulated entity) will result in all claims and expenses being paid from advanced receipt of reinsurance recoveries from NICO. This will impact the security and prompt settlement of claims.*
- 3. Capital*
- 3.1 The level and form of capital held by Transfercom is significantly different to that held by Sompo.*
- 3.2 As noted above, Sompo holds substantial cash and short term investments whereas the majority of Transfercom's assets comprise the reinsurance from NICO. The Independent Expert does not expressly evaluate the security offered by the NICO reinsurance as opposed to the Sompo cash and investments.*
- 3.80 I have considered the counterparty credit risk on both the fixed interest bond held by Transfercom and the NICO reinsurance contract in my revised assessment set out in Section 3.28 and following, and described in detail in Appendix C (in particular, in Sections AC.10 to AC.16).
- 3.3 Likewise, no consideration appears to have been given to the counterparty security and in particular whether the \$30 million debt equity which forms part of Transfercom's net assets would be inadmissible under the counterparty exposure limits and/or NICO's ability to perform under the reinsurance. In relation to the latter it is not clear how the potential failure of NICO and/or the non-recovery under the reinsurance has been modelled. In addition, it is not stated*

whether there are any group guarantees protecting against the failure of Transfercom or NICO.

- 3.81 I have considered the counterparty credit risk on both the fixed interest bond held by Transfercom and the NICO reinsurance contract in my revised assessment set out in Section 3.28 and following, and described in detail in Appendix C (in particular, in Sections AC.10 to AC.16).
- 3.82 There are no group guarantees in place which protect against the failure of either Transfercom or NICO with respect to the existing business within Transfercom or the transferring business. As a result I have considered the security levels of Transfercom and NICO in isolation and not in respect of the wider Berkshire Hathaway group.
- 3.4 Critical from the point of view of the transferring policyholders will be easy enforceability of the reinsurance with NICO. Is there any opinion from independent counsel confirming that the reinsurance contract will be effective? If not, we would expect such an opinion to be obtained. If there is such an opinion we would expect to have sight of a copy.*
- 3.83 I have obtained an independent legal opinion on the operations of the reinsurance contracts with NICO. The independent lawyer's opinion is set out in Appendix D.
- 3.84 The legal opinion refers to both the existing reinsurance policy written by NICO, covering the existing business of Transfercom (the "2006 Reinsurance Contract") and the new reinsurance policy which will come into force on the Proposed Scheme becoming effective, covering the transferring business (the "2010 Reinsurance Contract" and together with the 2006 Reinsurance Contract the "Reinsurance Contracts"). In addition it covers the Funds Withheld Endorsement to the 2010 Reinsurance Contract and an endorsement to the 2006 Reinsurance Contract which requires NICO to post security in a Trust Fund to cover its expected future obligations under the contract in the event that it is downgraded to below a BBB+ rating by Standard & Poor's (the "BBB Endorsement").
- 3.85 My understanding of the legal opinion is that:
- It is not likely that Transfercom could lose the benefit of the reinsurance cover with NICO due to, for example, late notification, time bar, breach of policy terms, exclusions or cancellation. In particular:
 - The right of NICO to be able to avoid the Reinsurance Contracts on the basis of a misrepresentation or non-disclosure is severely limited by Clause 10 of the Reinsurance Contracts.
 - Clause 10 of the Reinsurance Contracts also makes it clear that NICO may not decline to indemnify Transfercom even in the case of a negligent misrepresentation.
 - Settlements made by Transfercom with its reinsureds will be covered by the reinsurance with NICO where Transfercom has entered into them in an honest and businesslike manner and determined that the claim falls within the inwards policy.

- While it is theoretically possible that a claim by Transfercom could become time-barred, the reinsurance contracts with NICO do not seek to impose any shorter period than that provided under general law, and so this is unlikely to be an issue in practice.
- Nothing in the Reinsurance Contracts provides that they may be terminated or will otherwise come to an end as a result of a transfer of the ownership of Transfercom.
- No rights exist to permit transferring policyholders to claim directly against NICO in place of Transfercom.
- NICO does not have any rights of claims control over claims made against Transfercom by transferring policyholders, which could in turn become claims made by Transfercom against NICO.
- In each of the Reinsurance Contracts there is a provision requiring NICO to indemnify Transfercom in respect of what are termed "Internal Expenses and Fees". The definition of Internal Expenses and Fees is sufficiently broad to cover the fees and expenses incurred by Resolute in the management of the run-off of the business.
- While as a matter of English law the transfer of a policy governed by non-English law will be effective as a result of the Court's order sanctioning the Scheme, this may not be recognised in the jurisdiction whose law is the governing law of the policy. In respect of a policy where the Part VII transfer is not recognised as transferring it to Transfercom, so that a claim is successfully brought against Sompo after the Effective Date of the Scheme
 - Transfercom will not be able to claim under the 2010 Reinsurance Contract in respect of such a claim; and
 - NICO will be liable to indemnify Sompo in relation to losses under any such policy, with no limit of indemnity applying to such recoveries.

Payments thus made will not reduce the limit under the 2010 Reinsurance Contract.

- The Funds Withheld Endorsement provides that Transfercom must pay to NICO interest (at a rate calculated with reference to the 3-month US Treasury Bills (secondary market) rate plus 100 basis points) on the average balance of the funds. It is, therefore, possible that Transfercom will have to pay interest to NICO which exceeds the amount of any return on the investments, since Transfercom's obligation to pay interest is not limited either to the amount of the return it in fact obtains or to the value of any remaining investments representing the funds withheld.
- If, under the Funds Withheld Endorsement, NICO requires Transfercom to pay the funds withheld into a trust, the amount which Transfercom must pay is not reduced as a result of any reduction in the value of the underlying investments. Similarly, in determining whether any amounts must be repaid by Transfercom to NICO it is not clear that any reduction is to be made to reflect investment losses. Consequently, if Transfercom must pay sums under these provisions, they may exceed the value of the underlying investments at that time.
- Under the BBB Endorsement, the funds will be transferred to Transfercom in the form of securities and it is intended that those securities could be liquidated in order to pay

claims. Problems may therefore arise in the event that the securities are illiquid. Further, the BBB Endorsement requires Transfercom to re-pay certain amounts to NICO if the balance of funds at an accounting date is greater than "Remaining Reserves" (as defined). Issues may therefore arise in the event that the securities held significantly reduce in value between the accounting date and the date on which repayment must be made. Similarly, if NICO's rating recovers, Transfercom may be required to re-pay the balance of the retained funds. Given that there is no provision for reducing those funds to reflect a reduction in value of the underlying securities, it is possible that Transfercom will in those circumstances have to pay back an amount greater than the then current value of the underlying securities. Against this, however, as the funds (whether held by Transfercom or by a third party trustee) will be held in trust, it is clearly arguable that the liability to pay back should be construed as being limited to the extent of the funds remaining in the trust at that time.

- 3.86 It is therefore my opinion that it is appropriate to assume that the reinsurance contracts with NICO will be fully effective (except if NICO becomes insolvent) when opining on the likely effects of the Proposed Scheme on the affected groups of policyholders.
- 3.87 The situation where I am assuming that the reinsurance with NICO may not be fully effective (i.e. if NICO becomes insolvent) has been allowed for in my updated capital model, including the potential positive impact of the BBB Endorsement and Funds Withheld Endorsement on the likely recoveries from NICO in this event.
- 3.88 In respect of the last three bullet points listed under Section 3.85 above, Andrew Wilson's witness statement states that:

"Transfercom will invest any sums it receives in investments with high liquidity, of short duration and/or easily realisable and with very high security (by which I refer to investments having at least a AA- rating). It would be important to me to have a very high regard to the cash-flow profile of the claims arising from the Transferring Business in particular when making such investments. It is very likely that Transfercom would purchase short duration (ie, 3 months or less) US Treasury Bills with such funds, which I believe to have the above characteristics (US Treasury Bills have a AAA rating). Where appropriate, Transfercom would hold these Treasury Bills to maturity (which will guarantee that they are redeemed at least at par value). Transfercom will also retain a proportion of the funds withheld in cash from which it can recover sums due from NICO under the New NICO Reinsurance Contract"

Transfercom would wish for the terms of the trust fund to permit it to transfer into such trust fund any securities (ie, the Treasury Bills) it had invested the Funds Withheld in, plus any cash retained to pay claims I believe that this would be reasonable given the short-term nature of such investments and this would also remove any theoretical possibility that Transfercom could inadvertently crystallise an investment loss if it were to liquidate the investments in order to pay cash into the trust fund (because, as explained above, by holding the Treasury Bills to maturity in the trust fund, it would be guaranteed that those Treasury Notes would be redeemed at least at par value)."

In my view the proposed investment strategy as set out in Andrew Wilson's witness statement, and repeated above, removes any theoretical risk due to the security levels of Transfercom's policyholders deteriorating due to the issues discussed in the penultimate

bullet point of Section 3.85. In my view the risks raised in the final bullet point of that section are sufficiently remote that they can be ignored.

I have however updated my capital model to reflect the fact that, based on the proposed investment strategy set out in Andrew Wilson's witness statement, Transfercom will be required to pay interest to NICO based on the return Transfercom is likely to earn plus 100 basis points, the effect of which is to reduce the future projected capital levels of Transfercom. The results of my updated capital model are set out in detail in Appendix C.

The effect of all other clauses of the Funds Withheld Endorsement and BBB Endorsement can only be to improve the security levels of Transfercom's policyholders after the Proposed Scheme.

3.5 Whilst the capital ratios held by Sompo and Transfercom are roughly comparable (7.7% for Transfercom and 8.3% for Sompo), the concentration of the risk is a material and additional factor which the Independent Expert does not seem to have considered. Transferring policyholders are reliant upon a far less diversified portfolio and the financial stability of a single reinsurance counterparty in the form of Transfercom/NICO. Moreover, Transfercom is nothing more than a small and insufficiently capitalised run-off vehicle in complete contrast with Sompo a substantial well capitalised and secure insurer with continuing business and the liquidity to pay claims without delay (cf 2.3 above).

3.89 I have considered the specific situation of Transfercom, its portfolio of business, its reinsurance protection and its capitalisation as part of my assessment of security as summarised in Appendix C, including a number of references to my Previous Reports.

3.90 I have addressed the issue of liquidity in Sections 3.74 to 3.79 above.

3.6 The Independent Expert does not appear to have considered the FSA's capital requirements of either Sompo or Transfercom, although he states that Enhanced Capital Requirement calculations were reviewed. In addition, there is no indication that the implications of the EU's forthcoming risk based capital management regime (Solvency II) has been considered and whether under Transfercom regulatory effectiveness will be diminished.

3.91 As set out in Sections 3.59 to 3.62 above I have based my capital assessment around the FSA's ICA regime.

3.92 I have not specifically assessed the likely effects of the Proposed Scheme on the basis of the requirements of the Solvency II regime, which is not due to come into force until 31 December 2012. Its precise requirements are still uncertain. However, broadly I would not expect the introduction of Solvency II capital requirements to affect my assessment of relative policyholder security pre and post transfer. The Solvency II regime is to be calibrated at the same 99.5% 1 year value-at-risk measure as the ICA regime which I have used as a benchmark to assess if capital levels post transfer are satisfactory.

3.93 Within the UK sub-group of which Transfercom is part, Berkshire Hathaway International Insurance Limited ("BHIL"), as the only active (non run-off) company in that sub-group, is leading the preparation for the implementation of Solvency II for all of the UK companies in the sub-group, including Transfercom. Using the processes developed by BHIL,

Transfercom has just completed a gap analysis between their existing procedures and the requirements of Solvency II. I understand that no serious short-comings have been identified and there is an implementation plan in place to address such issues as were identified, including the appointment of a dedicated Group Compliance Officer and Risk Manager.

- 3.94 Transfercom took a high level view of the fourth Quantitative Impact Study ("QIS4") and as a result took a decision to opt for a standard formula approach for setting its Standard Capital Requirement ("SCR").
- 3.95 At present Transfercom has neither net written premium or net reserves, so the key considerations under the Solvency II standard formula will be:
- the treatment of reinsurance counterparty risk, including how this will apply for reinsurance from a non-EU reinsurer in a regime which may not achieve "equivalence" at the time of first implementation of Solvency II; and
 - the treatment of its corporate bond holdings.
- 3.96 The capital impact of this provisional decision on Transfercom will be tested by the fifth Quantitative Impact Study ("QIS5") which is scheduled to run between late August and November 2010. Transfercom will participate in this exercise and its work is very nearly complete so that Transfercom will be reporting the results to the FSA shortly.
- 3.97 Based on this work plan I consider Transfercom's preparations for Solvency II are satisfactory.
- 3.98 As the full implementing measures for the Solvency II Pillar I legislation emerge and the actual requirements of Solvency II become clearer, Transfercom intends to monitor the impact on its capital requirements. Based on the current drafting of the Solvency II legislation and the current specification of the proposed SCR standard formula I do not anticipate any issues with the level of capitalisation of Transfercom or the way in which its capital is structured.
4. *Set-off*
- 4.1 *The proposed transfer will cause Riverstone to lose its valuable set-off rights against Sompo.*
- 4.2 *RIUK has a right of set-off arising from 1,010 inwards reinsurance contracts where RIUK reinsured Sompo or its predecessors. This equates to over \$1.4 billion of available limits. The potential for future adverse claims development and the secure financial position of Sompo means that these rights are valuable and should be replicated.*
- 3.99 I understand that Riverstone are referring to the possibility of Riverstone being able, in some circumstances, to deduct sums owed to Riverstone by Sompo in respect of the transferring policies from amounts they may owe to Sompo under contracts where Riverstone acts as a reinsurer to Sompo. As Riverstone does not act as a reinsurer to Transfercom then a similar scenario cannot arise post-transfer.

- 3.100 I have obtained an independent legal opinion on this issue. My understanding of the legal opinion is that the legal right of Riverstone to do this is only relevant in the event that Sompo (pre-transfer) or Transfercom (post-transfer) are unable to pay a claim as a result of their insolvency.
- 3.101 I therefore regard the issue of set-off (in an insolvency situation) as one which may further increase the effective security levels of the transferring policyholders pre-transfer but has no effect on the security level of the transferring policyholders post-transfer.
- 3.102 The key conclusions of my assessment of the position of transferring policyholders as set out in Section 3.45 (which assessment does not take account of any potential set-off rights) are:
- that the level of security for the transferring policyholders will reduce if the Proposed Scheme is approved, but
 - that the level of security of the transferring policyholders would remain satisfactory.
- 3.103 I therefore consider that any allowance for potential set-off issues would not change the key conclusions of my assessment.

5. *Enforceability of the transfer*

5.1 *It is unclear that the transfer would meet the threshold test of enforceability.*

5.2 *The sampling exercise conducted by Resolute Management Limited to identify the governing law of the transferring policies was inadequate and flawed. The sample related to less than 1% of the transferring contracts; no details have been given as to how the sample contracts were selected; and there is no explanation of the basis of the extrapolation of the result for 69 contracts (0.67%) to the rest of the policy population.*

- 3.104 I do not consider the legal issues around the enforceability and recognition of the Proposed Scheme to be within the scope of the issues I am required to consider as an Independent Expert. I have however addressed in Sections 4.13 to 4.16 below the more specific question (which is within the scope of my role) of the impact that any such non-enforceability or non-recognition of the Proposed Scheme would have on the security levels of the different sets of policyholders.

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Section 4: Responses to objections raised by Axa

Introduction

- 4.1 In this section I set out my comments, and responses to, the objections raised by Axa. To aid the reader, I have repeated the specific objections raised by Axa in *orange italics* below (including repeating the numbering used by Axa). My comments and responses follow thereafter in black.
- 4.2 In some cases the objections raised by Axa relate to the same issues as those raised by Riverstone. In these cases I have provided a cross reference in this Section to my responses in Section 3 to the issues raised by Riverstone.
- 4.3 I have only provided comments and responses to those objections which I believe relate to matters within my expertise. Further, in accordance with the instructions I received in the Instruction Letters from Lovells, I have not addressed issues raised by Axa which relate to requests for documentation or underlying data.

Responses to objections raised by Axa

AXS CS objects to Sompo's Part VII transfer to Transfercom on the following grounds:

Background

1. *AXA CS (AXA Corporate Solutions Assurance) ("The Objector") is a Société Anonyme situated at 4 rue Jules Lefebvre in Paris. It specialises in underwriting large multinational companies but also deals exclusively with Marine and Aviation insurance on behalf of the AXA Group.*
 2. *Fortress Re was a managing Agency and underwrote on behalf of Japanese insurers save for Tokio Marine & Life. The Objector was satisfied with its involvement with Fortress Re as it offered an [sic] good level of security.*
 3. *The Objector has a branch in Asia and has a good relationship with Sompo. The Objector however does not wish for its policies to be managed as run-off.*
 4. *The Objector was significantly affected by the WTC. Claims are still being made by fireman/police officer/residents who are developing serious disease due to the dust from the WTC. It is therefore very difficult to estimate reserves in relation to future claims. As direct insurer, the Objector has therefore posted reserves up to Policy limits in relation to the aviation risk related to the WTC as has the US market. The Objector has concerns regarding the adequacy of the reserves posted by Sompo.*
- 4.4 As set out in Section 3.8 above the approach taken by Sompo to reserving World Trade Center losses has been to follow the basis of presentation of the losses by the cedant. Further in my analysis of reserving uncertainty set out in Sections AC.19 to AC.32 below I have allowed for possible deteriorations from Sompo's reserving position.

5. *On 26 March 2010 The Hon. Mr Justice Floyd ordered that policyholders claiming to be adversely affected must communicate their objections and concerns to Messrs Lovells by 5pm on 1 April 2010 and that further evidence may be served not less than 14 days before the adjourned hearing which is to be fixed not before 24 May 2010.*

Objections and Concerns

Inadequate Disclosure Of Documents

6. *The failure to disclose the documents expressly referred to in the Independent Expert's report of Graham Fulcher dated 21 January 2010 (the Fulcher Report) and listed in Appendix C to the Fulcher Report means that it is not possible to analyse the report in detail and the Objector can only question the basis of the findings and identify omissions. Therefore the Objector reserves the right to apply for disclosure of the underlying documents under or by analogy with CPR 31.14(2) and to clarify or expand its objections or make such new objections as may prove necessary.*
7. *The Fulcher Report (and supplemental report) are fundamentally underpinned by the actuarial reports referred to and listed. These go to the root of the adequacy of reserves. The Objector submits that these documents are part of the report and therefore Sompo is in breach of its notice obligations under the Financial Services and Markets Act 2000 (Control of Business Transfers) (Requirements on Applicants) Regulations 2001.*

- 4.5 This objection relates to a disclosure matter. In my view such matters are not within the scope of my role as Independent Expert and in accordance with my instructions (as included in Appendix B) will not be addressed in this report.

Independence Of Independent Expert

8. *Whilst the Independent Expert has properly declared his potential conflicts it is evident that his firm derives business from Sompo, Transfercom and Berkshire Hathaway. All of these stand to gain by approval of the transfer. If the Independent Expert did not support the proposal, it would be awkward for his firm and result in considerable wasted costs for its client.*
9. *Whilst the Objector does not suggest that the Independent Expert has not tried to be totally independent, it is essential that the Independent Expert should be beyond suspicion or criticism. The standard to be applied in this case should be particularly rigorous because the effect of this transfer would be to reduce the security available to existing Sompo policyholders based on a subjective assessment of unpredictable and uncertain future liabilities in respect of volatile run-off business. Insofar as the Independent Expert has relied on the underlying actuarial reports of Martin White and his actuarial colleagues at Resolute Management Services Ltd as at 30.09.2009 for Transfercom and Ronald Wilson of Beneficial Consultants LLC and the PwC report of Donald Farnan these have not been disclosed and so the subjective element of reserving adequacy has no transparency.*

- 4.6 As stated in Section 2.35, I have confirmed that I understand my duty to the Court, I have complied with that duty and I will continue to comply with that duty.

- 4.7 Axa have also raised points which relate to the matter of whether certain documents or underlying data should be disclosed to the objectors. In my view such matters are not within the scope of my role as Independent Expert and in accordance with my instructions (as included in Appendix B) will not be addressed in this report. However, as I have explained in Section 3.22 to 3.27 and Section 4.28 of this report, I am satisfied that it was entirely reasonable for me to rely on those reports referred to by Axa in preparing this report.

Extent of review

10. *There has been no audit of Transfercom or NICO. More significantly, there has been no review of systems and controls. Sompo is a long established reinsurer of high repute whose systems and controls can be expected to be excellent. Transfercom is a recently created special purpose vehicle and therefore the question of whether its systems and controls are adequate is an important one which should be addressed.*

4.8 Transfercom has been in operation since 2007 and is subject to FSA oversight and regulation. I have spoken to the FSA in connection with the Proposed Scheme and, in addition, the FSA approved the form of my Independent Expert Report. The FSA did not raise any issues concerning the systems and controls that Transfercom operates and I have no reason to believe there are any such issues which would affect my conclusions. I have also reviewed the audited year-end accounts of Transfercom since its inception and there has not been any reference in those account to any inadequate systems or controls. From my review of the audited accounts of Transfercom it has paid US\$46.5 million of claims in respect of the existing business since its inception up to 31 December 2009 (the date of the last annual accounts) which in my view demonstrates that Transfercom has valid systems and controls to enable it to pay valid claims.

4.9 Furthermore as discussed in Sections 5.5 and 5.6 of my Independent Expert Report it is the intention of the Proposed Scheme for the servicing of the transferring business to remain with Resolute who have been acting as the run-off agent for Sompo in respect of the transferring business since 1 April 2008. In addition the intention of the Proposed Scheme is for the servicing of the transferring business to proceed after the transfer fully in accordance with existing standards of service and of systems and controls around claims processes. The only exception to this is that I understand that currently Sompo requires an external legal opinion to be sought before confirming the payment of claims of greater than US\$0.5 million. Transfercom will not maintain this practice after the Proposed Scheme is effective. In my view this will only improve the situation for transferring policyholders by facilitating payment of large claims.

Reliance on unverified data and information

11. *If the Independent Expert has relied on unverified information then the authority of the whole report is undermined.*

4.10 UK actuarial guidance for general insurance reports as set out in GN12 states that "The report must indicate the sources of the data that the member has used and the extent to which he or she takes responsibility for data accuracy or completeness. The member may need to rely on or use the work of others".

4.11 Analogously to the conclusion in Section 3.25 above, the FSA's guidance in SUP 18 makes it clear that the Independent Expert may rely on information provided by others.

4.12 As stated in Section 1.20 of my Independent Expert Report I have where possible reviewed the information provided for reasonableness and consistency with my knowledge of the insurance and reinsurance industry.

Jurisdiction issues

12. *Policies written by the Objector are subject to French Law and/or contain a French seat of arbitration.*
13. *The Independent Expert has not addressed the possibility that the proposed transfer may not be recognised in other jurisdictions and has not analysed or considered whether this could have an effect on Sompo policyholders particularly in relation to Fortress Re business.*
- 4.13 I asked an independent legal expert to address the implications of this possibility as part of the legal opinion requested on the operation of the reinsurance contracts as mentioned in Section 3.83. The key conclusions of his opinion are set out starting at Section 3.85.
- 4.14 In respect of the specific issue raised: while as a matter of English law the transfer of a policy governed by non-English law will be effective as a result of the Court's order sanctioning the Scheme, this may not be recognised in the jurisdiction whose law is the governing law of the policy. In respect of a policy where the Part VII transfer is not recognised as transferring it to Transfercom, so that a claim is successfully brought against Sompo after the Effective Date of the Scheme
- Transfercom will not be able to claim under the 2010 Reinsurance Contract in respect of such a claim; and
 - NICO will be liable to indemnify Sompo in relation to losses under any such policy, with no limit of indemnity applying to such recoveries.
- 4.15 Payments thus made under such policies will not reduce the limit under the 2010 Reinsurance Contract
- 4.16 It is therefore my opinion that, at worst, the security of the affected groups of policyholders will be substantially unaffected if the transfer is not recognised in respect of any policies ("Non-Recognised Policies"), based on the following reasoning for each affected group of policyholders:
- Policyholders remaining in Sompo. Any claims from Non-Recognised Policies will be recoverable by Sompo from NICO, without limit. The benefit of these potential recoveries is offset, but only to a limited extent, by the counterparty credit risk attaching to these potential recoveries. In my opinion, though, the security of the policyholders remaining in Sompo will be substantially unaffected by any such claims.
 - Policyholders transferring from Sompo UK to Transfercom and the existing policyholders of Transfercom. If there are any claims from Non-Recognised Policies these will be recoverable by Sompo from NICO without reducing the limit under the 2010 Reinsurance Contract. Hence, the security of the policyholders in Transfercom after the Proposed Scheme will be improved compared with the situation if there were no Non-Transferring Policies, although in my opinion any such improvement will be marginal.

Finality for Sompo

14. *Whilst the expressed intention may be for Sompo to achieve finality and concentrate on its core business, this is not simply a re-organisation. The reality is that a sound reinsurer would be walking away from the most "toxic" cocktail of business – aviation reinsurance, with WTC*

exposure, property cat business, marine and non-marine reinsurance and retrocession business.

Reduction in security

15. *The Independent Expert refers to the FSA solvency criterion of 99.5% value at risk over a one year time horizon and accepts that this would be reduced to 97.5%. Whether or not the solvency criterion is met is irrelevant for this particular book of business because it is long tail and uncertain including in particular low layer aviation losses such as WTC. The reference to percentages and what appears to be only a small percentage reduction – although in fact 2% could be significant – obscures the reality. It is a fact that the policyholders will be subject to greater financial risk if the transfer is made.*
16. *The Independent Expert opines that the level of security will remain satisfactory. This is an entirely subjective comment. No reduction is satisfactory to the Objector. A one year timeline is too short to judge the long term run-off.*
- 4.17 I have set out in Sections 3.59 to 3.70 above the objective basis for my assessment of security (including the effective equivalence of the 99.5% value at risk over one year and 97.5% run-off to ultimate levels of security) and why the post-transfer level of security for transferring policyholders remained in my view satisfactory.
- 4.18 In addition I have set out in Appendix C and summarised in Sections 3.33 to 3.52 the results of my revised analysis which sets out more clearly the security levels for the transferring policyholders over the term to run-off of this business.
17. *Sompo's ratings are AA3 (Moody's) and AA- (Standard & Poor's). It is the second largest insurer in Japan. If it is ever in financial difficulty, there will be huge political pressure on the Japanese Government to assist (as in the case of AIG in the US). It has \$6 billion of capital and reserves. The Independent Expert describes Sompo as "a large well diversified and strongly capitalised company". Transfercom is not rated. It has capital of only \$45 million. The position of NICO and Berkshire Hathaway is not directly relevant as the Objector has no contract with them.*
18. *Transfercom's existing business includes books of bad and uncertain business including Yasuda asbestos exposure, Nissan US XL exposure including Weavers, Nissan pool business dating back to the 1970s, Nissan WTC exposure and ex-Nissan treaties with asbestos exposure. The Objector would be exposed to the financial risk of a deterioration of this existing Transfercom business beyond reserves and reinsurance protection.*
- 4.19 My assessment of Transfercom's security made explicit allowance for its capital resources and for the uncertainty in the reserving position of the existing book. As set out in Section 3.70 above my assessment of the 97.5% level of security was directly based around the probability that the existing Transfercom business exhausts the reinsurance protection and available capital.
- 4.20 Details of the updated modelling approach I have followed, and the results of the analysis, are set out in Appendix C.

Future underwriting

19. *The Independent Expert says that there will be a reduction in exposure to underwriting risk and no significant increased new business risk. The Objector cannot see how the Independent*

Expert can logically reach this conclusion. Transfercom is a run-off vehicle. It is potentially a dumping ground for undesirable business and there is no reason to doubt that it will continue to take on more run-off of this type in the future.

20. *Sompo is getting out of this undesirable business while Transfercom is getting into it. Thus there is a significant new business risk.*
- 4.21 As explained in Section 5.10 of my Independent Expert Report I have considered the possibility of such a transfer. In the event that such a transfer was proposed it would (under current legislation) be subject to Court approval, with the process including scrutiny by the FSA and provision of an independent expert's report considering the impact of the scheme on, inter alia, the security and service levels of existing Transfercom policyholders and the possibility for those policyholders to register their objections to the transfer.
- 4.22 This is exactly the current situation for the existing policyholders of Transfercom who are being protected against the risk of this Proposed Scheme by these mechanisms and who, if the Proposed Scheme proceeds, stand to improve their own security levels by way of an extended reinsurance protection.

NICO Treaty

21. *The principal asset of Transfercom is the NICO reinsurance. Its terms have not been disclosed. Sompo policyholders have no contractual rights under this reinsurance as far as the Objector is aware, whereas at present the policyholders have direct rights against Sompo.*
22. *No information has been disclosed or considered by the Independent Expert as to the circumstances in which Transfercom could lose its cover, with no recourse for the Objector, for example due to late notification, time bar, breach of policy terms, exclusions or cancellation.*
23. *The Independent Expert has not analysed claims control provisions and considered how these could affect the policyholders.*
- 4.23 I have asked the independent legal expert to address these specific issues as part of the legal opinion requested on the operation of the reinsurance contracts as mentioned in Section 3.83. The opinion of the independent lawyer is set out in Appendix D and the key conclusions of his opinion are set out starting at Section 3.85 .
- 4.24 In summary his conclusions are that:
- It is not likely that Transfercom could lose the benefit of the reinsurance cover with NICO due to, for example, late notification, time bar, breach of policy terms, exclusions or cancellation
 - NICO does not have any rights of claims control over claims made against Transfercom by transferring policyholders, which could in turn become claims made by Transfercom against NICO.

Transfercom and NICO

24. *Whilst Transfercom and NICO are subsidiaries of the same Group, it cannot be assumed that disputes will not arise between these companies in the future.*

Administration

25. *Run-off agent, Resolute, is a subsidiary Berkshire Hathaway Group as is Transfercom. There is a potential conflict of interests. The Independent Expert has not considered what if any controls are in place to control the fees being paid to Resolute if Transfercom's funds become severely depleted. No information is given on the extent to which the NICO reinsurance covers such administration expenses. The terms of the fee structure and in particular how it will be controlled in the long term have not been considered or disclosed.*

4.25 I asked the independent legal expert to advise me on the extent to which the Reinsurance Contracts cover administrative expenses. His conclusion was that in each of the Reinsurance Contracts there is a provision requiring NICO to indemnify Transfercom in respect of what are termed "Internal Expenses and Fees". The definition of Internal Expenses and Fees is sufficiently broad to cover the fees and expenses incurred by Resolute in the management of the run-off of the business.

4.26 As set out in Section 3.5 of my Independent Expert Report, the reinsurance policy covering the existing business of Transfercom covers up to US\$50 million of unallocated loss adjustment expenses paid from 1 March 2007 until either the limit of US\$50 million is exhausted or the main policy limit is exhausted. In respect of the reinsurance policy covering the transferring business, as set out in Section 3.8 of my Independent Expert Report, up to US\$25 million of unallocated loss adjustment expenses are covered, from the effective date of the Proposed Scheme until either the limit of US\$25 million is exhausted or the main policy limit is exhausted. In Sections 4.37 and 4.52 of my Independent Expert Report I confirm that in my opinion it is extremely unlikely that these ULAE reinsurance limits will be breached provided only such administration expenses as can be reasonably incurred are claimed against the contract.

4.27 Transfercom is an FSA-regulated firm and as such I do not consider it reasonable for me to need to consider the possibility that Transfercom will act improperly and pay fees to Resolute that are not warranted or reasonable.

Reserve Uncertainties

26. *Heavy reliance has been placed on the undisclosed PwC Report of Donald Farnan. There is no reference to any qualifications, reservations or caveats in PwC's predictions. Given the long tail, the susceptibility of this type of business to deterioration and future litigation, it is unjust that the Objector faces the risk of such predictions being inaccurate when the Objector has not seen the report or had the opportunity to provide input into such predictions. The fact that the Independent Expert found significant flaws in the PwC Report simply illustrates how uncertain the future reserving is.*

4.28 The reference to my Independent Expert Report finding "significant flaws" in the PwC Report is incorrect. The PwC report was in my view entirely adequate for the purposes for which it was originally commissioned by Sompo. The reference given by Axa is to Section 4.35 of my Independent Expert Report. In that Section I comment on the one area where I felt that the PwC report was not entirely adequate for *my* purposes. In Sections 4.35 to 4.37 of that report I have commented on the additional information I requested and received which allowed me to gain a full understanding of the reserving issues around uncertainty.

4.29 As a result of the objections received after my Previous Reports and particularly in light of the developments in the claims on the transferring business since the date of my Previous

Reports, I requested further data and conducted further analysis. I have set out some further comment on this in Sections 3.15 to 3.21 above.

Aggregation and accumulation of risks

27. *No consideration has been given to the extent to which existing Sompo policyholders may have an increased dependence on NICO security in view of the Equitas Part VII transfer and whether this poses undesirable financial risks.*

4.30 In my Independent Expert Report, my Supplemental Report and this Second Supplemental Report, I have considered the likely effects of the Proposed Scheme on matters including the security of policyholders' contractual rights and the levels of service provided to policyholders, as set out in SUP 18. I have not considered the extent to which individual transferring policyholders may have increased overall exposure to NICO as, in my view, provided that the security of contractual rights and levels of service are satisfactory this is not an issue within the scope of my Independent Expert's role.

Solvency II

28. *No consideration has been given to the potential effects of the Solvency II requirements on Transfercom.*

4.31 See my comments in Sections 3.91 to 3.98 above.

The Objector reserves the right to expand on or clarify its objections as necessary and to submit further evidence as may be required in accordance with paragraph 3 of the Order or The Hon. Mr Justice Floyd of 26 March 2010.

These objections shall not constitute an admission of liability under any policy, a waiver of any reservation or an affirmation of any specific policy.

Section 5: Responses to objections raised by LRA

Introduction

- 5.1 In this section I set out my comments, and responses to, the objections raised by LRA. To aid the reader, I have repeated the specific objections raised by LRA in *orange italics* below (including repeating the numbering used by LRA). My comments and responses follow thereafter in black.
- 5.2 In some cases the objections raised by LRA relate to the same issues as those raised by Riverstone and/or Axa. In these cases I have provided a cross reference in this Section to my responses in Sections 3 and 4 to the issues raised by Riverstone and Axa.
- 5.3 I have only provided comments and responses to those objections which I believe relate to matters within my expertise. Further, in accordance with the instructions I received in the Instruction Letters from Lovells, I have not addressed issues raised by LRA which relate to requests for documentation or underlying data.

Responses to objections raised by LRA

We thank you for your letter dated 29 March 2010 enclosing the orders made by Mr Justice Floyd on 26 March 2010.

In light of the Court's orders, we set out below the objections of La Réunion Aérienne ("LRA") (made for itself and for its participants) to the proposed transfer of insurance business from Sompo Japan Insurance Inc ("Sompo") to Transfercom Limited ("Transfercom").

Insurance and reinsurance business is governed by foreign law and jurisdiction.

1. *Fortress Re Inc. ("Fortress Re") was a managing agency in Burlington, North Carolina that grew out of Penn General Agencies. Fortress Re underwrote reinsurance primarily on behalf of Japanese companies, notably Nissan, Chiyoda and Taisei; the latter companies' Letters of Authority to Fortress Re are attached.*
2. *By the 1990's, national and international aviation reinsurance had become the principal business written by Fortress Re in North Carolina on behalf of the Japanese capital. Fortress Re ceased underwriting in 2003 as a result of heavy losses on all four planes involved in 9/11 (United Airlines and American Airlines) and the later American Airlines crash in Queens.*
3. *Nissan subsequently merged with Yasuda (another Japanese company, not involved in Fortress Re) in 2002, to form Sompo, an insurance company incorporated in Japan.*
4. *LRA's involvement with Fortress Re is comprised of reinsurance treaty cessions for the period 1984 to 2003. The attached list of 187 treaties shows Sompo's (ex Nissan) share in Fortress Re's participation in LRA's treaties over the period 1984 – 2003, including net outstanding loss figures at 31 December 2009.*
5. *By dint of (a) the international nature of the reinsurance business to be transferred and (b) the fact that Sompo itself has no assets in the UK, there are genuine doubts about whether the transfer will be recognised outside the UK and thus whether any purpose would be served by*

a UK court giving its sanction to the transfer: see [In the matter of Sompo Japan Insurance Inc and Transfercom Limited](#) [2007] EWHC 146.

6. *In this regard, it is certainly the case that the LRA's reinsurances are subject to French law and jurisdiction. It is also believed that, in light of the history as set forth above, the majority of the various other reinsurances are likewise subject to a foreign law and jurisdiction.*
 7. *It is now said by Sompo that they (or rather Resolute on their behalf: see paragraphs 20 to 25 of the First Witness Statement of Miss Nishijima dated 25 January 2010) have conducted a "sampling exercise" of the reinsurances in an effort to determine the applicable law of the reinsurances. It seems that they reviewed 80 of the 10,374 contracts (ie 0.77%, albeit apparently representing 70% of current claims reserves) and found that for 69 contracts the governing law was the law of the domicile of the reinsured. They then extrapolated that conclusion to the remaining 10,294 contracts and concluded that 58% were governed by UK law (sic) with the 42% balance governed by EEA, USA and other.*
 8. *But this sampling process is flawed. A sample size of 0.77% of the population is insufficient to draw any statistically significant conclusions as to the population. By way of example, if one wanted to test a population of 1200 with a confidence limit of 95%, one would need to draw upon a sample of 60 (ie 5%). Moreover, in order to be a true sample, the sample pool must be chosen at random – ie by some method that gives each member of the population an equal chance to be selected for sampling. That did not happen here: instead, Sompo pre-selected those 80 that represented the bulk of the claims – but the weight of claims is entirely irrelevant to the governing law.*
 9. *Even assuming that one may deduce that the reinsurances are governed by the law of their domicile, so that the conclusions arrived at by Sompo are correct, there is still a significant proportion of reinsurances that fall to be determined by a foreign law (and jurisdiction), such that the efficacy of the scheme with respect to those reinsurances is in doubt. It is not at all clear that the French or US courts would recognise a statutory transfer of reinsurance obligations imposed on the cedants by an English court.*
- 5.4 I do not consider the legal issues around the enforceability and recognition of the Proposed Scheme to be within the scope of the issues I am required to consider as an Independent Expert. I have however addressed in Sections 4.13 to 4.16 above the more specific question (which is within the scope of my role) of the impact that any such non-enforceability or non-recognition of the Proposed Scheme would have on the security levels of the different sets of policyholders.
10. *It is noted in passing that the entire list of "transferred policies" should have been included in the Schedule of the Scheme attached to the Framework Agreement (NNI page 36 of 63). This page has not been completed.*

The transfer will increase LRA's exposure to Berkshire Hathaway

11. *LRA ceded its business to Fortress Re in the United States on the basis that the capacity would be provided by a panel of well-secured Japanese companies. This was a deliberate decision on the part of LRA.*
12. *LRA is already heavily dependent on Berkshire Hathaway as a reinsurer. Of its current reinsurance protections, approximately one third (611 of 1850 reinsurers) are with Berkshire Hathaway. LRA has no wish to be compelled to take on any further exposure.*
13. *In circumstances where diversity of reinsurance cover is plainly very important, LRA's view is that it is unfair that it should be subjected to a significant increase in exposure to the Berkshire Hathaway group.*

- 5.5 In my Independent Expert Report, my Supplemental Report and this Second Supplemental Report, I have considered the likely effects of the Proposed Scheme on matters including the security of policyholders' contractual rights and the levels of service provided to policyholders, as set out in SUP 18. I have not considered the extent to which individual transferring policyholders may have increased overall exposure to NICO, or the Berkshire Hathaway group more widely, as, in my view, provided that the security of contractual rights and levels of service are satisfactory this is not an issue within the scope of my Independent Expert's role.

The transfer will give rise to a reduction in security

14. *As noted by the Expert at page 18/26 para 4.11, 4.13 and at 4.56:-*
- "4.11 Prior to the transfer the transferring policyholders are subject to the security of Sompo Japan and not the security of the UK branch in isolation."*
- "4.13 Sompo is a large, well diversified and strongly capitalised group with a conservative policy for reserving and for dividend payments. It is very strongly rated by both Moody's and Standard & Poor's at a rating level which would imply a security level well beyond the FSA's ICA solvency criterion of 99.5% value-at-risk over a one year time horizon".*
- "4.56 The transferring policyholders are moving from a large, well diversified and strongly capitalised company, whose rating level implies a security level well beyond the FSA's ICA solvency criterion of 99.5% value-at-risk over a one year time horizon".*
15. *The proposed transfer will however, as is accepted by the Expert, give rise to a reduction in security – it is said that the likelihood of Transfercom being able to pay all future claims is estimated to be 97.5% (based on the Expert's modelling, which LRA has not seen).*
16. *Even if that estimate is right, which is open to question (see below), LRA fails to see why it should be compelled to accept any reduction whatsoever in its reinsurance security.*
- 5.6 I have set out in Sections 3.59 to 3.70 above the objective basis for my assessment of security (including the effective equivalence of the 99.5% value at risk over one year and 97.5% run-off to ultimate levels of security) and why the post-transfer level of security for transferring policyholders remained in my view satisfactory.
- 5.7 In addition I have set out in Appendix C and summarised in Sections 3.33 to 3.52 the results of my revised analysis which sets out more clearly the security levels for the transferring policyholders over the term to run-off of this business.

Transfercom is inadequately capitalised

17. *The capitalisation of Sompo is set out at page 11, par 3.17 of the Expert's Report and shows that, as at 31 March 2009, capital and reserves stood at US\$6 billion.*
18. *By contrast, Transfercom's capital resources (to be shared between existing and transferring policyholders and apparently not to be increased after the proposed transfer: Expert's Report at para 3.11) are as follows:*
- a) *\$43 million, plus \$2 million retained profit, of which \$30 million is invested in a 10-year fixed interest debt security and for which there is therefore both a credit risk and a liquidity risk;*
- b) *an existing NICO reinsurance policy in respect of existing business, which provides for net claims paid since 1 March 2007 up to a limit of \$482 million, of which \$25 million has been eroded;*

- c) *a new NICO reinsurance policy which is said (at page 10, para 3.8 of the Expert's Report) to be intended to cover all future net claim payments in respect of the business to be transferred after 31 March 2009, with a limit of \$277.1 million, with cover for loss adjustment expenses of \$25 million (albeit subject to the overall limit); and*
- d) *an asset said to be \$4.5 million which the Expert states at para 3.10 "relates to funds withheld in respect of Sompo's share of certain business written by Fortress Re" (it is not clear what this means) which is to be assigned to NICO in any event (and thus may be ignored).*
19. *For LRA, it is unacceptable that the reinsurance protections (for which it has paid hefty premiums) are to be transferred from a company with capital and reserves of \$6 billion to a company with non-reinsurance assets of \$45 million (albeit a subsidiary of a larger group).*
20. *Still further, Sompo currently owes LRA \$23 million, excluding IBNR, representing 8.30% of the NICO reinsurance cover, yet it is apprehended that the other Fortress Re cedants represent more than 91.70% of Fortress' Re's book. The ability of the NICO cover to respond has nowhere been explained.*
21. *In this regard, it is also noted that RiverStone has \$5 million unpaid balances whilst LRA had \$6,983,141 at December 2009 increasing to \$15,630,247 by February 2010, out of a total of \$25.7 million (see Expert Report at page 21, para 4.25).*

5.8 The detailed assessment of the security level of transferring policyholders set out in Appendix C allows in detail for the nature of the capital resources of Transfercom, and the risks to those resources, including:

- The free capital. The analysis considers the credit and liquidity risk in respect of the bond holding in Sections AC.13 to AC.16.
- The protection provided by the reinsurance contracts with NICO including the counterparty risk in respect of the contracts (see Sections AC.10 to AC.12) and the risk that the contracts are not adequate due to deteriorations in reserving positions (see Sections AC.19 to AC.40).

Lack of transparency of NICO Treaty

22. *Apart from Transfercom's capital of \$45 million, the only other capital resource is the reinsurance treaty with NICO. The reinsurance treaty with NICO is therefore critical to the survival of Transfercom and its ability to meet Sompo's current contractual obligations to the transferring policyholders.*
23. *It appears from what is said at "Appendix C – Information Considered" (Page 37 of the Expert's Report) that the reinsurance treaty to cover the transferring business was not reviewed by the Expert. Indeed, the only comment by the Expert is that NICO is the reinsurer for "all net claims in respect of the transferring business paid after 31 March 2009 up to a limit of \$277.10 million with no retention" (paragraph 3.8 at page 10).*

5.9 At the time of finalisation of my Independent Expert Report the proposed reinsurance treaty between Transfercom and NICO had not been put in place. I was, however, provided with the level of cover for the proposed new reinsurance contract and also reviewed, as listed in Appendix C on page 37 of my Independent Expert Report:

- The Framework Agreement between Sompo, NICO and Transfercom setting out the way in which the proposed transfer would be effected, including the setting up of the reinsurance contract

- The existing reinsurance agreement with NICO protecting the existing business of Transfercom, which I was instructed would form the basis of the wording and operation of the reinsurance contract covering the transferring business except in respect of the particulars of the business covered and in particular the level of cover of the proposed new contract.

5.10 In my opinion this information was sufficient to enable me to form my judgement as to the effect of the Proposed Scheme on the different groups of affected policyholders.

24 The NICO treaty has now been exhibited to Mr Michael's First Witness Statement dated 25 January 2010, together with a sideletter from NICO to Transfercom. Now that it has been made available, one would expect the Expert to consider its terms thoroughly and carefully in order to understand whether it provides adequate protection.

5.11 The final reinsurance treaty was signed on 10 March 2010 and the terms of the contract match the understanding of its operation that I used in preparing my Independent Expert Report.

5.12 In addition, as stated in Section 3.83 above, I have taken independent legal advice to confirm my understanding of the operation of the contract with specific focus on questions raised in written objections to the Proposed Scheme (including by LRA at paragraph 25 of their objections). I have also taken legal advice on the effect of a small number of endorsements made to the contract since 10 March 2010, in particular the Funds Withheld Endorsement.

25 The NICO treaty gives rise to a number of immediate questions. One, will the treaty survive the sale of Transfercom to another party? If so, how is that achieved? If not, what mechanism is in place to provide for the continuation of security? Two, what is the premium (and why has it been redacted from the copy made available to the policyholders)? The premium is plainly important to any assessment as to the protection provided by the treaty. Should there be a significant difference between premium and cover (given potentially low interest rates going forward), NICO's future ability to pay may be affected. Alternatively, if there is no or little difference, the cover provided should be improved.

5.13 In respect of the first question I asked the independent legal expert to address these specific issues as part of the legal opinion requested on the operation of the reinsurance contracts as set out in Section 3.83. The key conclusions of his opinion are set out starting at Section 3.85.

5.14 In respect of the second question please see the response above to Riverstone's first (unnumbered) objection as set out at Sections 3.4 and 3.5 of this report.

5.15 Riverstone's comment related to the difference between the premium and the current levels of reserve whereas LRA's comment relates to the difference between the premium and the level of cover provided.

5.16 As stated in Section 3.4, I was made aware of the premium and in my opinion although there is a difference between the premium and the level of cover provided that difference is not at all material compared to the total resources of NICO, whose total assets at

31 December 2009 were US\$79.2 billion and of which 48% related to free assets. LRAs first concern (regarding a difference between the level of premium and level of cover impacting NICO's future ability to pay) is therefore not valid.

- 5.17 In respect of the second concern (regarding if there is no or little difference, the cover provided should be improved), as stated in Section 3.4 of this report, I did not, as part of the work underlying my Independent Expert Report, carry out any specific work to consider the reasonableness (or otherwise) of this premium. Rather I allowed for the effect of the proposed reinsurance policy (and the premium paid) as one of the elements in considering the effect of the Proposed Scheme (in its totality) on the different sets of policyholders. In addition, as set out in Section 1.14 of my Independent Expert Report, I did not consider any possible alternative schemes.
- 26 *It might even be preferable that the (undisclosed) sum received by Transfercom from Sompo be retained by Transfercom in cash assets to pay future claims. At least, Transfercom would benefit from any interest that might accrue. Without knowing the full details of the transfer and the treaty premium, it is impossible to assess the true value of the NICO treaty with any accuracy.*
- 5.18 I did not originally consider this query relevant to my role as Independent Expert. As set out in Sections 1.12 and 1.13 of my Independent Expert Report, my role as Independent Expert was to consider the likely effects of the Proposed Scheme on the security and levels of service of different sets of policyholders. However I note the Funds Withheld Endorsement has been added to the reinsurance contract with NICO to cover the transferring business, as described in Sections 3.78 and 3.79 above.

Reserves and IBNR

- 27 *The total case reserves plus IBNR and related amounts (including a \$57 million credit reinstatement premium) amount to \$211 million. (The Expert Report para 4.25 shows \$211,000, but it is assumed the figure is in millions rather than thousands). These figures were prepared by PriceWaterhouseCoopers.*
- 28 *A large proportion of the business to be transferred will contain WTC losses. Using LRA's own portfolio ceded to ex-Fortress Re as an example, the sum of outstanding losses arising from events of the WTC accounts for approximately 80% of the total outstanding losses at 31 December 2009. LRA anticipates that this level of exposure is broadly indicative of the entire business.*
- 29 *Additionally, it is LRA's belief that there is real potential for the development of asbestosis claims in the Aviation market for the years in question.*
- 30 *LRA has genuine concerns as to the Expert's lack of analysis of the transferred case reserves and IBNR exposure to WTC and asbestos losses in particular. The Expert does not appear to have considered this aspect of the proposed transfer.*
- 5.19 As set out in Section 3.53 above, as part of drafting my Independent Expert Report I carried out detailed consideration of the uncertainty surrounding the transferring reserves including asbestos and WTC exposures. I have set out in Sections 3.15 to 3.17 of this report comments on developments in the transferring reserves over the period since 31 March 2009 and some comments on asbestos exposure in Sections 3.54 to 3.56 of this report.

Fees

31 *The NICO treaty provides for the sum of \$25 million (in addition to claims) in respect of unallocated loss adjustment expenses. The latter are not defined in the NICO treaty. No assessment can therefore be made regarding the adequacy of the NICO cover in this respect. For example, it is not known whether unallocated adjustment expenses include such things as Resolute's fees, Transfercom's salaries or Transfercom's rent.*

5.20 As set out in Section 4.25 above I asked the independent legal expert to advise me on the extent to which the Reinsurance Contracts covers administrative expenses. His conclusion was that in each of the Reinsurance Contracts there is a provision requiring NICO to indemnify Transfercom in respect of what are termed "Internal Expenses and Fees". The definition of Internal Expenses and Fees is sufficiently broad to cover the fees and expenses incurred by Resolute in the management of the run-off of the business.

5.21 In relation to LRA's specific query, once the Proposed Scheme is effected, Transfercom will not have direct salaries and costs, but instead indirect costs incurred by Resolute which acts as a service company within the Berkshire Hathaway UK group. Resolute will raise a quarterly fee to Transfercom which will include an allocation (based on monthly timesheets) of both salaries and office overheads (including rental). The fee will include a split between the costs in relation to the existing and transferring business and each set of fees will be recoverable from the appropriate NICO reinsurance contracts.

5.22 I address the adequacy of the indemnity for unallocated loss adjustment expenses in Section 4.26 above.

32 *The costing details of the Run-Off Services Agreement with Resolute have been redacted. These should be made available, for without them it is not possible to assess the level of service to be provided with its cost.*

5.23 This objection relates to a disclosure matter. In my view such matters are not within the scope of my role as Independent Expert and in accordance with my instructions (as included in Appendix B) will not be addressed in this report.

No consideration of Solvency II

33 *Solvency II will reshape the capital adequacy requirements for the European insurance industry. It is due to be implemented in October 2012 – ie soon after this proposed transfer – yet no discussion appears anywhere in the Expert's Report as to the import of Solvency II and the impact of the new requirements on Transfercom.*

34 *According to the Association of Run-Off Companies ("ARC"), Solvency II will mean onerous capital requirements and higher expenses for the run-off sector in which Transfercom operates. ARC say that this would create an unreasonable capital burden on the run-off sector, and that the reporting and data quality requirements could result in unaffordable additional expenses for run-off companies. What does the Expert say about this?*

35 *There is no discussion by the Expert as to whether Transfercom would or would not be subject to Solvency II as a result of the following criteria:*

- a) Transfercom's annual gross premium;*
- b) Transfercom's gross technical provisions;*

- c) *the Berkshire Hathaway group's gross technical provisions;*
- d) *inclusion in Transfercom's business of liability, credit, suretyship risks; and*
- e) *percentage of reinsurance within Transfercom's overall business.*

36 *The Expert does not appear to have grappled with the effect that Solvency II may have on Transfercom's survival as an ongoing concern, its ability to meet the new capital requirements, nor the extra costs involved in compliance.*

5.24 See the comments in Sections 3.91 to 3.98 above.

5.25 In addition as set out in Section 4.26 above, the administrative expenses of Transfercom are covered by the reinsurance contracts with NICO. It is in my view extremely unlikely that the levels of ULAE cover in these contracts will be breached even with allowance for any additional costs of Solvency II implementation and compliance.

37 *In paragraph 18 of Miss Nishijima's Second Witness Statement (dated 18 March 2010), it is said that the FSA certifies that Transfercom will meet solvency requirements after the transfer. Having looked at the certificate, LRA consider that the FSA certificate is not clear in this regard.*

Transfercom's exposure

38 *LRA as a transferring policyholder is being asked to exchange the security of Sompo, which is "a substantial non-life insurance company listed on the Tokyo stock exchange" (Expert's Report at page 10, para 3.13) for that of Transfercom, whose existing business (as described at page 13, para 3.29) comprises: (a) run-off of asbestos exposures; (b) exposures to US commercial carriers; (c) WTC exposures and (d) US liability exposures.*

39 *Furthermore, there is no guarantee or even binding assurances regarding the acceptance by Transfercom of additional distressed portfolios in the future. This would further weaken Transfercom's non-reinsurance capital base.*

5.26 My capital model to assess the Post Scheme Position of the policyholders transferring from Sompo UK to Transfercom (as well as the Pre and Post Scheme Position of the current policyholders of Transfercom) explicitly allows for the reserving uncertainty in the existing business of Transfercom, including allowance for the nature of the exposures in that business.

5.27 Notwithstanding these factors my overall conclusion is that the level of security for the transferring policyholders remains satisfactory.

5.28 In respect of the possibility of Transfercom acquiring further portfolios of business, see the comments in Sections 4.21 and 4.22 above.

40 *LRA as a transferring policyholder finds the uncertainty resulting from such exposures unacceptable, even with the FSA's involvement in such a transfer.*

FSA's ICA solvency criteria

41 *The Expert estimates that Sompo currently has "a security level well beyond the FSA's ICA solvency criterion of 99.5% value-at-risk over a one year time horizon" (para 4.56). It is said at para 4.59 that "the probability of Transfercom being able to pay all future claims to the*

transferring policyholders (and avoiding insolvency) after the Proposed Scheme would be approximately 97.5%.”

- 42 *The Expert does not explain how these percentages are calculated, nor does he provide the origin of the data used for these assessments. LRA is therefore being asked to accept these matters as read in circumstances where this conclusion by the Expert is plainly of the utmost importance to his assessment of the efficacy of the proposed scheme. This is a most unsatisfactory state of affairs.*

5.29 See the comments starting in Section 3.59 above.

Monies owed to LRA

- 43 *As at February 2010, LRA and its principals are owed by Sompo the sum of \$15,630,247. Net outstanding losses at the same date are estimated at \$1,994,298, not including IBNR. A recent (confidential) arbitration award has resulted in a further, yet to be determined, amount due to LRA calculated at approximately \$5.3 million. This produces a total of approximately \$23 million due to LRA, excluding IBNR.*
- 44 *This sum alone represents approximately 8.30% of the reinsurance cover provided by NICO's treaty to Transfercom of \$277.1 million (which includes IBNR) in respect of all transferring policyholders. LRA is not aware of the identity or magnitude of the other policy holders (save AXA, France's largest insurer, and RiverStone), but would expect them to represent more than 91.70% of Fortress Re's book.*
- 45 *LRA estimates its percentage share of the benefit of the NICO treaty to be uncomfortably high, and consequently has serious doubts as to its adequacy.*

5.30 I can confirm that the amounts quoted above by LRA for the percentage share of the total unpaid reserves of the transferring book of business relating to LRA as a cedant are consistent with the reserving position of the transferring book of policies which formed the basis of my analysis of the adequacy of the NICO treaty in Sections AC.19 to AC.32 below.

Office of Foreign Assets Control (“OFAC”)

- 46 *LRA has exposure on certain treaties with countries currently on the OFAC List or which may, in the future, fall within the List as a result of OFAC directives. If LRA were to be reinsured by a reinsurer belonging to a group domiciled in USA which will be obliged to comply with such a directive, LRA's exposure would be prejudiced.*

5.31 My understanding of the objection LRA is raising is as follows. LRA is suggesting that it may be disadvantaged as a result of its contracts moving from a company whose group is not headed by a US company (Sompo) to a company whose group is headed by a US company (Transfercom). LRA's concern is that its ability to successfully bring a claim against its reinsurer may be adversely affected by the transfer, as Transfercom but not Sompo would be subject to sanctions imposed by the United States Treasury Office of Foreign Assets Control (“OFAC”). LRA is further suggesting that it has contracts which are impacted by sanctions against countries on the OFAC list.

5.32 I have obtained independent legal input on this issue, which is included in Appendix D.

5.33 My understanding of this legal input is that:

- The only OFAC sanctions program that would apply differently to Transfercom than to Sompo would be OFAC's Cuba sanctions, which would apply even to entirely non-US dealings of Transfercom with Cuba on the basis of the US ownership of Transfercom
- Complying with those OFAC sanctions relating to Cuba is a criminal offence under EU and UK law, so it is my opinion that there is no prospect of Transfercom refusing to pay a claim in order to comply with them.

5.34 I do not therefore consider that OFAC would lead to any differences in the ability of LRA (or any other cedant) to bring a claim against Transfercom post transfer as opposed to bringing it against Sompo pre-transfer.

5.35 I therefore do not consider OFAC to be an issue that has any effect on my conclusions.

The Transfer

- 47 *It is proposed that Sompo transfer an undisclosed amount representing \$237.1 liabilities to Transfercom who in turn has obtained (in exchange for an undisclosed premium) a guarantee of \$277.1 million plus \$25 million in respect of (not defined) unallocated expenses to settle all current unpaid balances, all future claims and all IBNR. The guarantee has been obtained from a reinsurance company whose solvency has not been assessed.*
- 48 *As a transferring policy holder, LRA considers this arrangement to be the equivalent of a forced commutation with Sompo. In fact, it is worse than a forced commutation since LRA is obliged to share the commutation fund both in time and in amount with its co-cedants, and this fund will exhaust on a first-come first-served basis. In addition, LRA is being asked to pay the additional expenses of its new reinsurer.*
- 49 *Remaining with Sompo as reinsurer would be the equivalent of an unlimited reinsurance treaty. Why should LRA be forced to exchange such a protection for a monetarily limited treaty with NICO?*
- 50 *In this regard, it appears plain enough that Transfercom does not exist and operate in its own right as a reinsurer. It was incorporated for the singular purpose of attracting the jurisdiction of the English court under Part VII of FSMA.*
- 51 *It is LRA's opinion that the proposed scheme in general is simply a device to cap NICO's and Berkshire Hathaway's exposure to the novation it has offered to Sompo at the expense of the transferring policy holders, and as such should be rejected.*

5.36 I have taken full account of the nature of Transfercom, its reinsurance protection with NICO and the counterparty credit risk of NICO in my analysis in Appendix C and in my conclusion in Section 3.45 that the security level of transferring policyholders while reduced post-transfer still remains adequate.

Disclosure

- 52 *The proposed scheme has been put to policyholders without full disclosure of the underlying documents on which the Expert formed his view. In order to assess the Expert's Report and in order to form a considered view as to the proposed scheme, LRA require disclosure of the following documents:*
- a) *the Run-Off Management Agreement between Sompo and Transfercom;*
 - b) *the 2008 and 2009 annual reports for Sompo;*

- c) the 2008 and 2009 annual reports for Transfercom;*
- d) the FSA returns for Transfercom for years ending 31 December 2007 and 31 December 2008;*
- e) the outsourcing agreements for Transfercom;*
- f) the reinsurance contract between National Indemnity Company and Transfercom which covers the existing business of Transfercom;*
- g) the annual statements for National Indemnity Company as at 31 December 2007 and 31 December 2008;*
- h) the actuarial report undertaken by Martin White and his actuarial colleagues at Resolute Management Services Ltd as at 30 September 2009 for Transfercom;*
- i) the unaudited half-year management accounts of Sompo as at 30 September 2009;*
- j) the unaudited management accounts of Transfercom as at 31 December 2009; and*
- k) "Transfercom 31.12.2008 Reserves for Losses and Losses Expense" prepared for Transfercom on 28 March 2009 by Ronald Wilson of Beneficial Consultants LLC ("The Wilson Report").*

53 *We should also be grateful to receive clean (non redacted) copies of the following documents:-*

- a) Framework Agreement dated 1 October 2009*
- b) NICO Reinsurance Agreement dated 10 March 2010*
- c) NICO Reinsurance Agreement dated 1 December 2006*

We look forward to receiving the Expert's further report, if any, as soon as it is available. Should you or the Expert have any questions arising from any of these matters, please contact us as a matter of urgency.

5.37 This objection relates to a disclosure matter. In my view such matters are not within the scope of my role as Independent Expert and in accordance with my instructions (as included in Appendix B) will not be addressed in this report.

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Section 6: Responses to objections raised by ACE

Introduction

- 6.1 In this section I set out my comments, and responses to, the objections raised by ACE. To aid the reader, I have repeated the specific objections raised by ACE in *orange italics* below (including repeating the numbering used by ACE). My comments and responses follow thereafter in black.
- 6.2 In some cases the objections raised by ACE relate to the same issues as those raised by Riverstone and/or Axa and/or LRA. In these cases I have provided a cross reference in this Section to my responses in Sections 3, 4 and 5 to the issues raised by Riverstone, Axa and LRA.
- 6.3 I have only provided comments and responses to those objections which I believe relate to matters within my expertise. Further, in accordance with the instructions I received in the Instruction Letters from Lovells, I have not addressed issues raised by ACE which relate to requests for documentation or underlying data.

Responses to objections raised by ACE

I, Nicholas Thales Michaelides, of 100 Leadenhall Street, London, EC3A 3BP, will say as follows:

Introduction

- 1 I am the Chief Reinsurance Officer for ACE Overseas General which comprises the operations of ACE Underwriting Agencies Limited and ACE European Group Limited (among others).*
- 2 This witness statement is served on behalf of ACE Underwriting Agencies Limited (for and on behalf of Syndicate 2488) and ACE European Group Limited.*
- 3 ACE Underwriting Agencies Limited is the managing agent managing the business underwritten by Syndicate 2488. Syndicate 2488 underwrites specialty London market business. ACE European Group Limited also underwrites specialty London market business with the addition of retail property, casualty and accident and health business. For ease of reference, and unless otherwise specified, the various ACE entities shall be referred to as ACE.*
- 4 I am authorised by ACE to make this statement in opposition to the application by Sompo Japan Insurance Inc ("Sompo") for the sanction of the Court of a transfer of reinsurance business from Sompo to Transfercom Limited ("Transfercom") pursuant to Part VII of the Financial Services and Markets Act 2000.*
- 5 Save where indicated otherwise, the facts stated in this statement are my own knowledge. Where they are not within my knowledge they are true to the best of my information and belief and derived from the sources indicated.*
- 6 There is now shown to me a paginated bundle marked "NTM", to which I shall refer in the course of this statement.*

ACE's involvement with Sompo

- 7 *ACE's involvement with Sompo is comprised of reinsurance treaty cessions for the period 1981 to 2004.*
- 8 *ACE European Group Limited has entered into approximately 164 reinsurance treaties with Sompo in respect of which there are outstanding balances. Syndicate 2488 and its predecessor syndicates have entered into approximately 53 reinsurance treaties with Sompo in respect of which there are outstanding balances. One of those, an Aviation Excess of Loss treaty between Syndicate 2488 and Sompo in respect of losses occurring on risks attaching during the 12 month period from 1 November 2000 (broker reference A02488105), has unpaid and outstanding amounts of approximately US\$11.92 million, which represents the majority of the total outstanding balances due to ACE from Sompo of approximately US\$12.015 million*
- 9 *Most of the outstanding reinsurance recoveries due to ACE from Sompo relate to aviation losses, which I expect to mature within the next five years. ACE is therefore potentially exposed to Sompo for at least that period.*

Reduction in security

- 10 *In the Report of Mr Fulcher dated 21 January 2010 (the "Report"), Mr Fulcher has concluded that: (i) the level of security of policyholders of Sompo transferring to Transfercom will reduce if the proposed scheme is approved; and (ii) the level of security of transferring policyholders will remain satisfactory after the proposed scheme.*
- 11 *In reaching the conclusions, Mr Fulcher has asserted that Sompo's rating level implies a security level well beyond the FSA's ICA solvency criterion of 99.5% value at risk over a one year time horizon. He has also concluded that the likelihood of Transfercom being able to pay all future claims is 97.5%.*
- 12 *Mr Fulcher does not explain why, in his opinion, the level of security of transferring policyholders will "remain satisfactory". ACE considers that the present level of security, corresponding to "well beyond" the FSA's ICA solvency criterion of 99.5% value at risk over a one year time horizon, is a great deal better than satisfactory. This is consistent with the fact that Sompo has capital and reserves exceeding \$6 billion.*
- 13 *ACE does not consider that Mr Fulcher's assertion is appropriate in the circumstances, because he does not explain the basis on which he considers that the level of security of transferring policyholders (ie 97.5% after the proposed transfer) is "satisfactory". In particular, Mr Fulcher does not state or estimate Transfercom's value at risk over a one year time horizon after the proposed transfer; he does not estimate the present likelihood of Sompo being able to pay all future claims of transferring policyholders; and he does not state how far Sompo's value at risk over one year is beyond 99.5%, ie what he means by "well beyond".*
- 14 *ACE has sought to make a meaningful comparison of its security before and after the proposed scheme by reference to a study of default rates carried out by Standard & Poors ("S&P") (NTM) and entitled "2008 Annual Global Corporate Default Study and Rating Transitions."*
- 15 *Table 14 provides the average rate of default for AA ratings. The cumulative average default rate of an AA rating over a 5 year horizon is 0.34% (and the collection probability is 99.66%). Since Sompo carries an AA- rating from S&P, the average default rate for an AA- rating over a 5 year horizon will be slightly higher than 0.34%*
- 16 *This contrasts with the probability estimated by Mr Fulcher in relation to Transfercom of 97.5%, which corresponds to a 2.5% likelihood that policyholders will not all be paid in full. Mr Fulcher does not specify the time horizon over which his calculation is based, and it may be that it is longer than 5 years.*

- 17 *2.5% is a multiple of over seven times 0.34%. To put these figures in their simplest terms, they equate to a 1 in 300 default probability for Sompo over 5 years as opposed to a 1 in 40 default probability for Transfercom.*
- 18 *Moreover, Mr Fulcher has not confirmed that Transfercom's security level meets the FSA's solvency criterion of 99.5% value at risk over a one year time horizon.*
- 6.4 See my comments at Sections 3.59 to 3.72 above.
- 6.5 In addition I agree with the figures that ACE quote in paragraph 15. The 2009 version of the same paper Standard & Poor's report "Default, Transition, and Recovery: 2009 Annual Global Corporate Default Study And Rating Transitions" (the "S&P 2009 Default Study") has updated data and also shows a further analysis by rating modifier (that is AA- and AA+ are shown separately to AA). The 2009 equivalent figure for a AA- rating is a cumulative average default rating of 0.46% (with a collection probability of 99.54%). I have made use of these default rates in my more detailed modelling in Appendix C.
- 6.6 In addition in the more detailed modelling in Appendix C I have set out the differential security positions for the two sets of policyholders and compared them to the FSA's solvency criteria of a 99.5% value at risk over a one year time horizon.
- 19 *Mr Fulcher states in paragraph 1.5 of the Report that he has complied with Guidance Note 12 adopted by the Board for Actuarial Standards in the UK. Paragraph 8.1 of that Note states that a report "should normally indicate the nature, degree and sources of uncertainty surrounding the results and sensitivities to key assumptions. Uncertainty should normally be quantified where practicable, but otherwise should normally be reported using an appropriate descriptive summary."*
- 20 *The key figures in the Report are Mr Fulcher's estimates of Sompo's security level of "well beyond 99.5%", and the likelihood of Transfercom being able to pay all future claims of 97.5%. Mr Fulcher does not quantify the uncertainty surrounding these figures and he provides no sensitivities to key assumptions.*
- 21 *I note, in this regard, that the existing business of Transfercom, referred to at paragraphs 3.29 and 4.43 of the Report and paragraph 3.22 of Mr Fulcher's Supplemental Report, contains a substantial exposure to asbestos, as well as environmental pollution and health hazard claims. These claims may take decades to emerge and are notoriously difficult to predict. For this reason, the transfer may well expose transferring policyholders to considerably more uncertainty than that to which they are currently exposed.*
- 22 *In addition, Sompo's capital and reserves (US\$6 billion) are vast as compared to Transfercom's (US\$45 million). This is also likely to mean that transferring policyholder will be exposed to increased uncertainty as a result of the transfer.*
- 6.7 The quantification of the likelihood of Transfercom being able to pay all future claims of 97.5% is precisely an attempt to quantify the uncertainty in the ultimate claims arising from the business in Transfercom and hence the uncertainty of Transfercom being able to meet all future claims after the Proposed Scheme.
- 6.8 This quantification is, of course, sensitive to various selected assumptions I have made in building my capital model. For those assumptions that are key or more uncertain, I have performed a sensitivity analysis to support the accuracy of my conclusions. This sensitivity analysis is set out starting at Section AC.61.

Cost of proposed transfer to ACE

- 23 *ACE is required to hold a bad debt reserve against its reinsurance recoverables. ACE's bad debt reserving policy is to apply a provision based on the rating of the reinsurer. Sompo is rated AA- which equates, according to ACE's policy, to a bad debt provision of 1.2% as against the total outstandings of \$12.015 million.*
- 24 *If the proposed transfer is approved, as Transfercom is unrated and is backed by a B rated investment bond, ACE must increase its bad debt reserve significantly, to 23.8% of US\$12.75 million, which is \$3,034,500 (i.e. an increase of US\$2,881,500).*
- 25 *The percentages used by ACE for this purpose are based on S&P default rates.*

Lack of information regarding the bond

- 26 *In paragraph 3.34 of the Report, Mr Fulcher states that Transfercom invested US\$30 million in 2008 in a ten year fixed interest debt security to be held until maturity. The bond was issued privately and attracted a NAIC SVO rating of 4, which is the equivalent of a rating from S&P of B. Mr Fulcher acknowledges that the bond holding carries credit and liquidity risk.*
- 27 *By an email sent on 19 March 2010, ACE's solicitors sought a small number of documents from Sompo, including a copy of the bond, and three of the reports and the capital model referred to in the Report. In its email response of 22 March, Lovells on behalf of Sompo sought a confidentiality agreement from Sompo, yet refused to provide these documents on the basis that they are "commercially sensitive and confidential". In a further email sent on the same day, Lovells again refused to provide details of the bond. In response to a further request, they identified the issuer, but have not disclosed a copy of the bond or its terms and conditions. In these circumstances, ACE does not know whether, for example, the bond pays interest and, if so, how much. This would appear to be a consideration which is material to the Report, but is not referred to in it.*
- 28 *Mr Fulcher states in paragraph 4.54 of the Report that his modelling of risk has made no allowance for the investment return to be earned on the capital levels of Transfercom during the run-off of claims, as in his view the positive impact on security is counterbalanced by the additional risk factors which he has not considered. The two particular counterbalancing risks are (i) the counterparty credit risk in respect of the reinsurance arrangements with NICO; and (ii) the additional risks associated with the form of capital of Transfercom, in particular the credit risk associated with the funds withheld asset of US\$4.5 million and both the credit risk and liquidity risk associated with the \$30 million bond holding.*
- 29 *As set out in S&P's study, a rating of B carries a default risk of 25.93% over an eight year time horizon, yet Mr Fulcher makes no explicit allowance for this. Nor does he consider the sensitivity of the likelihood of Transfercom's default due to a default on the bond.*
- 30 *Mr Fulcher's assumption that investment returns counterbalance the credit and liquidity risks he identifies is doubtful for at least two reasons. The first is that interest rates have lowered, so investment returns may have a reduced impact in future years. The second is that if the bond pays interest, this interest will not be paid if the note defaults.*

- 6.9 I have considered these risks as part of the more detailed analysis as set out from Section 3.28 of this report, and described in detail in Sections AC.33 to AC.36 in Appendix C.

Conclusion

- 31 *ACE purchased reinsurance from a highly solvent reinsurer in reliance on its high credit rating. If the transfer proceeds, it will face a marked but unquantified deterioration in its security and*

an increased risk in relation to outstanding reinsurance recoveries. It is respectfully submitted that for the reasons given above the proposed scheme should not be sanctioned by the Court.

- 6.10 I have set out in Sections 3.59 to 3.70 above the objective basis for my assessment of security (including the effective equivalence of the 99.5% value at risk over one year and 97.5% run-off to ultimate levels of security) and why the post-transfer level of security for transferring policyholders remained in my view satisfactory.
- 6.11 In addition I have set out in Appendix C and summarised in Sections 3.33 to 3.52 the results of my revised analysis which sets out more clearly the security levels for the transferring policyholders over the term to run-off of this business.
- 6.12 In Section 3.43 I have quantified the security level of the transferring business within Sompo and in Section 3.44 I have quantified the security level of the transferring business after the Proposed Scheme has been effected.

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Appendix A: Court Order (of 26 March 2010)

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IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

No. 625 of 2010

The Hon. Mr Justice Floyd
26th March 2010

IN THE MATTER OF SOMPO JAPAN INSURANCE INC.

-and-

IN THE MATTER OF TRANSFERCOM LIMITED

-and-

IN THE MATTER OF THE FINANCIAL SERVICES AND MARKETS ACT
2000



UPON THE APPLICATION of Sompo Japan Insurance Inc. ("Sompo"), whose principal place of business is at 26-1, Nishi-Shinjuku by claim form dated 25th January 2010 for (amongst other things) the sanctioning of a scheme pursuant to Part VII of the Financial Services and Markets Act 2000 ("the Act");

AND UPON HEARING Counsel for Sompo, Counsel for AXA CS and Counsel for ACE being policyholders of Sompo claiming to be adversely affected by the scheme;

AND UPON READING the claim form and the evidence

THIS COURT ORDERS THAT:

1. Any policyholder claiming to be adversely affected by the scheme communicate their objections and concerns to Messrs Lovells, solicitors acting for Sompo, by 5.00pm on 1st April 2010,

2. any further report by Mr . Fulcher, the Independent Expert approved under section 109 of the Act, be made available not less than 21 days before the adjourned hearing,
3. any further evidence on which any party wishes to rely be served not less than 14 days before the adjourned hearing,
4. any further report by the Financial Services Authority should be made available not less than 7 days before the adjourned hearing,
5. skeletons to be lodged by 10.00am on the day which is two days before the adjourned hearing;
6. further hearing of the claim form be adjourned to a date, not before 24th May 2010, to be fixed through the usual channels with an estimate of one day,
7. liberty to apply for an earlier date (if appropriate) or generally
8. Costs reserved.

Appendix B: Instructions from Lovells

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19 April 2010

Direct line +44 (0)20 7296 2074
nick.atkins@lovells.com
Direct fax +44 (0)20 7296 2001

Our ref D5JR/NMA/2497990.1
Matter ref F0051/00770

Watson Wyatt Limited
Watson House
London Road
Reigate
Surrey
RH2 9PQ

For the attention of: Graham Fulcher

Dear Sir

IN THE MATTER OF SOMPO JAPAN INSURANCE INC - CLAIM NO: 625 OF 2010

We refer to the above matter and your previous reports to the Court as Independent Expert in relation to Sompo Japan Insurance Inc's ("**Sompo**") proposed transfer of certain of its aviation reinsurance business to Transfercom Limited ("**Transfercom**") pursuant to Part VII of the Financial Services and Markets Act 2000 (the "**Scheme**"). We are writing on behalf of Sompo to request that you prepare a second supplemental report to the Court in the above matter. This request arises from three of Sompo's transferring policyholders (as set out below) having submitted written objections to the Scheme. These objections are attached at Appendix 1, tabs 2 to 4, to this letter.

We will set out the areas in which we believe you can assist the Court by preparing a second supplemental report. We first set out the background to this request.

BACKGROUND

When your previous supplemental report was prepared (8 March 2010), an application to approve the Scheme was listed to be heard by the Court on 26 March. It was originally anticipated that had the Court approved the Scheme on that date, the transfer of business would have taken place by 31 March 2010.

Between the submission of your supplemental report of 8 March 2010 and the date of the final hearing, a number of transferring policyholders raised certain objections to the Scheme. At the request of the FSA, Sompo requested an adjournment of their application for approval of the Scheme so that the queries and objections of those transferring policyholders could be articulated and analysed in full. The directions of the Court are embodied in the Order it made on 26 March 2010, which is included at Appendix 1, tab 1. Pursuant to that Order, any policyholder claiming to

be adversely affected by the Scheme was required to communicate their objections to Lovells by 1 April 2010 (paragraph 1 of the Order).

At the same hearing, one policyholder, Axa, applied to the Court for disclosure of documents reviewed by you in preparing your reports. The Court declined to hear this application at that time, but policyholders may apply to the Court for disclosure at a later date, should they choose to do so.

The hearing of Sompo's application to proceed with the Scheme is now adjourned until a date not before 24 May 2010 (paragraph 6 of the Order). The Court has ordered that any further report to be produced by you shall be made available no less than 21 days before the date of the adjourned hearing (paragraph 2 of the Order).

OBJECTIONS

On 1 April 2010 and in accordance with the Court's Order, Lovells received three written statements of objection to the Scheme. These were received from:

1. Fox Hartley on behalf of Axa Corporate Solutions Assurance ("**Axa**");
2. Reynolds Porter Chamberlain LLP on behalf of Riverstone Management Limited and Riverstone Insurance (UK) Limited (collectively "**Riverstone**"); and
3. Maitland Hudson & Co LLP on behalf of La Réunion Aérienne ("**LRA**").

NEXT STEPS AND SCOPE OF SECOND SUPPLEMENTAL REPORT

The objections raised by Axa, Riverstone and LRA concern, in large part, the facts and matters set out in your previous two reports to the Court. As such, this is to request that you review the objections and prepare a second supplemental report setting out your comments on and responses to these objections to the extent that you are able.

Obviously, it is for you to decide the structure of your further supplemental report. You should consider whether there are matters that you have addressed in your reports that require amendment, amplification or supplemental work. You will see that there is overlap between the three objections and it could be possible to group those objections into broader categories of objection but, we believe that it may be most efficient, and of most assistance to the FSA and the Court, if you address each policyholder's objections in turn (insofar as they relate to matters within your expertise), cross-referencing your other responses in the event of overlap.

You will also see that certain of the issues raised by Axa, Riverstone and LRA are, to a greater or lesser extent, requests for documentation or underlying data. Sompo and Transfercom are considering such requests and it may ultimately become necessary for these issues to be resolved by the Court. Therefore, this is not an issue that you need to address and we do not require you to collate and/or provide documents or data to the objectors.

Some of the issues raised by Axa, Riverstone and LRA relate to matters of actuarial practice where reliance has been placed by you on the work of others that has not been independently verified, specifically your reliance on the PwC, White and Wilson actuarial reports. Your opinion as regards what is common or generally accepted actuarial practice in these circumstances would be helpful, as would reference to any published guidance from professional bodies or institutions.

In dealing with the matters raised by Axa, Riverstone and LRA, you may decide that you require input from a lawyer. If you do, we confirm that you have Sompo's authority to instruct an

independent lawyer to provide you with such input as you may require, provided that all reasonable steps are taken to keep their fees to a reasonable and proportionate level.

We would be grateful for an indication of when we can expect to receive your second supplemental report.

If it would assist, both Resolute Management Limited and we are able to meet with you at your convenience to assist in providing any additional information or documentation you may require to assist in the preparation of your second supplemental report.

Should you have any queries, or require any further information, please do not hesitate to contact Jamie Rogers or Nick Atkins of Lovells LLP on 020 7296 5795/2074 or by email at jamie.rogers@lovells.com or nick.atkins@lovells.com.

Finally, we would add that this letter has been seen in draft and approved by the Financial Services Authority.

Yours faithfully

Lovells LLP

encs

cc: The Financial Services Authority
Fox Hartley, on behalf of Axa CS
Reynolds Porter Chamberlain LLP, on behalf of Riverstone
Maitland Hudson & Co LLP, on behalf of LRA

IN THE HIGH COURT OF JUSTICE

No: 625 of 2010

CHANCERY DIVISION

COMPANIES COURT

**IN THE MATTER OF
SOMPO JAPAN INSURANCE INC.**

- and -

**IN THE MATTER OF
TRANSFERCOM LIMITED**

- and -

**IN THE MATTER OF
THE FINANCIAL SERVICES AND MARKETS ACT 2000**

**APPENDIX 1 - ATTACHMENTS TO REQUEST TO GRAHAM FULCHER FOR SECOND SUPPLEMENTAL
REPORT**

1. Order of the Court dated 26 March 2010.
2. Written objections received from Fox Hartley on behalf of Axa Corporate Solutions Assurance on 1 April 2010.
3. Written objections received from Reynolds Porter Chamberlain LLP on behalf of Riverstone Management Limited/Riverstone Insurance (UK) Limited on 1 April 2010.
4. Written objections received from Maitland Hudson & Co LLP on behalf of La Réunion Aérienne on 1 April 2010.



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23 April 2010

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Our ref D5JR/NMA/2504766.1
Matter ref F0051/00770

Watson Wyatt Limited
Watson House
London Road
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Surrey
RH2 9PQ

For the attention of Graham Fulcher

Dear Sir

IN THE MATTER OF SOMPO JAPAN INSURANCE INC - CLAIM NO: 625 OF 2010

We refer to our letter of 19 April 2010 in which we, in conjunction with the FSA, requested that you prepare a second supplemental report for the Court covering the written objections submitted in the above matter. A copy is attached for your reference.

We have received a further written objection from Mayer Brown International LLP who represent ACE Underwriting Agencies Limited and ACE European Group Limited. This is in the form of a witness statement from Mr Nicholas Michaelides of ACE.

We request that you cover the points made in this witness statement in your second supplemental report and treat the document as if reference to it were incorporated into our letter of 19 April 2010.

Should you have any queries, or require any further information, please do not hesitate to contact us.

Yours faithfully



encs

cc: The Financial Services Authority
Mayer Brown International LLP, on behalf of ACE
Fox Hartley, on behalf of Axa CS
Reynolds Porter Chamberlain LLP, on behalf of Riverstone
Maitland Hudson & Co LLP, on behalf of LRA

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Appendix C: Modelling Approach

Modelling of security

- AC.1 In response to the queries raised by the various objectors I have built a more detailed capital model to assess the Post Scheme Position of the policyholders transferring from Sompo UK to Transfercom and the Pre and Post Scheme Position of the current policyholders of Transfercom.
- AC.2 The modelling approach I have followed is based on the approach undertaken to support my Previous Reports, with a number of changes which I discuss below. These changes were designed to address the queries raised by the various objectors. My capital model allows for a distribution of possible outcomes and for each group of policyholders assesses whether the claims will be paid in full. I have also updated my modelling for any revised information since the date of my Previous Reports.

Security levels of Transfercom

- AC.3 In respect of Transfercom (and hence the Post Scheme Position of the policyholders transferring from Sompo UK to Transfercom and the Pre and Post Scheme Position of the current policyholders of Transfercom) security is provided in the first instance by the specific reinsurance arrangements in place with NICO (which in turn are subject to the general security levels of NICO) for each set of policyholders, with further security provided by the net shareholder assets/free capital of Transfercom. There are no other assets backing the technical reserves. The free capital will be available for both sets of policyholders to utilise, after, and if, the Proposed Scheme is sanctioned, if claims exceed the upper limit of the applicable reinsurance protection with NICO.
- AC.4 If one of the books of business stayed within its reinsurance protection while claims from the other book of business erode on an actual basis or are projected on a future best estimate basis to exhaust not just the full extent of the applicable reinsurance protection but also the entire capital of Transfercom, then Transfercom would be insolvent. Such insolvency is likely to be at best a severe inconvenience to both sets of policyholders leading to a reduction in service standards and delay in claim payments. Further it is possible that in such an insolvency the full assets of Transfercom (including reinsurance recoveries) would be made available to settle, as far as possible on a pro-rata basis, the full liabilities of Transfercom. In this event, therefore, the payouts to policyholders of both books of business may be reduced (not just the policyholders covered by the exhausted reinsurance protection).
- AC.5 The key drivers in respect of the Post Scheme Position of the policyholders are:
- Reserve uncertainty on the book of business transferring from Sompo UK
 - Reserve uncertainty on the existing book of business in Transfercom
 - Correlations between the reserve uncertainty on the two books of business

AC.6 Other risks to the policyholders include:

- The counterparty credit risk in respect of the reinsurance arrangements with NICO
- The additional risks associated with the form of the capital of Transfercom. In particular, the credit risk and liquidity risk associated with the US\$30 million bond holding.

Revised modelling approach

AC.7 For the analysis which supported my Previous Reports:

- I made no specific allowance for the investment return to be earned on the capital levels of Transfercom during the run-off of claims, as I assumed that this was counterbalanced by also not considering the counterparty credit risk in respect of NICO and the liquidity and credit risk in respect of the US\$30 million bond holding. In my view this was a reasonable assumption.
- I treated the security levels of both books of business as identical and did not consider their very different payment profiles. This simplification represented a conservative view of security levels for the transferring policyholders and had no material impact on my assessment of security levels for the existing policyholders of Transfercom.

AC.8 A number of the objections received have centred around two issues:

- A requirement for an explicit treatment of investment returns, counterparty credit risk and liquidity risk
- A requirement to understand in more detail the security level of the transferring policyholders and the time frame over which the assessment of this level is made.

AC.9 In response to the objections raised I have updated my modelling approach in three main ways:

- First to alter the modelling assumptions to give explicit consideration to investment income and counterparty credit risk (and to discuss in more detail liquidity risk). This is described further in Sections AC.10 to AC.16 below.
- Secondly to present the results of the model to make allowance for the different expected future payment periods of the two sets of policyholders, as described further in Sections AC.17 and AC.18 below.
- Finally I have updated my assessment of reserve uncertainty for developments since the effective date of my Previous Reports. In light of the requirements of the updated approach and presentation this has included the need to allow for the payment pattern of the two sets of reserves (for the transferring and current business). This assessment is set out in Sections AC.19 to AC.40 below.

Revised treatment of counterparty credit risk in respect of the reinsurance arrangements with NICO

- AC.10 In my modelling I have allowed for the counterparty credit risk in respect of the reinsurance arrangements with NICO by allowing for the probability that NICO is upgraded, downgraded or defaults during the period of anticipated recoveries from NICO as the underlying claims are paid by Transfercom. I have taken the default probabilities used in my analysis from the S&P 2009 Default Study.
- AC.11 I have assumed that if NICO defaults then on average there would be a recovery of 50% on claims against NICO. I refer to this as the “recovery rate” assumption. This is in my opinion a reasonable assumption and is the same as the assumption proposed by CEIOPS in QIS4 and QIS5. In its final advice to the European Commission on “SCR Standard Formula – Counterparty Risk Default Model: Former Consultation Papers 28 and 51” CEIOPS comments “For defaulted reinsurance counterparties, an assumed recovery rate in the range of 50% seems to reflect best practice.”
- AC.12 Based on the legal advice I have received it is my understanding that the BBB Endorsement to the 2006 Reinsurance Contract and the Funds Withheld Endorsement to the 2010 Reinsurance Contract could both act to increase the recovery rate in the event that NICO defaults. I have not made any explicit allowance for this in my modelling but this in my view means that this assumption is more conservative than a best estimate.

Revised treatment of credit risk and liquidity risk associated with Transfercom’s US\$30 million bond holding

- AC.13 In my modelling I have allowed for the counterparty credit risk associated with Transfercom’s US\$30 million bond holding by allowing for the probability that both coupon payments and the redemption proceeds on the bond are not paid during the period up to maturity of the bond. I have taken the default probabilities used in my analysis from the Standard & Poor’s report “Default, Transition, and Recovery: 2009 Annual Global Corporate Default Study And Rating Transitions”.
- AC.14 In addition to credit risk, there is also liquidity risk attaching to the bond holding which arises from the possibility that Transfercom may need to transfer the bond prior to maturity, albeit I understand that Transfercom intend to hold the bond until redemption in October 2018.
- AC.15 The bond is held in the Transfercom accounts at its nominal value of US\$30 million. The bond is a private placement and therefore there is no quoted independent market value. Transfercom has the ability to assign the bond elsewhere in the Berkshire Hathaway group without the issuers consent and the Berkshire Hathaway group carries out regular private valuations of the bond. Assigning the bond outside the Berkshire Hathaway group would require the consent of the issuer. However, given the coupon on the bond (fixed at 11.45% per annum), the security rating and the outlook for interest rates, the bond is currently estimated to have a realisable (i.e. estimated sale) value significantly in excess of the nominal value at which it is held on Transfercom’s balance sheet. We have been provided with Berkshire Hathaway’s most recent private valuations of the bond as at 31 December 2009 and 30 September 2010. These valuations for the bond consider the publicly tradeable spread over treasury bills on marketable bonds from the same issuer, together with an additional premium for the relative illiquidity of a privately placed bond and for the subordinated nature of

the debt. These valuations both value the bond in excess of 120% of its nominal value, with the most recent valuation valuing the bond at US\$38.2 million. Rather than use this value in our modelling we have made the conservative assumption that if the bond is realised before maturity it is realised at nominal value, except in the event that NICO is in default on the reinsurance projections in which case we have assumed that the bond is realised at only 50% of the nominal value (reflecting the fact that the bond may need to be assigned outside of the group in those circumstances). We have assumed that the bond will always be realised at full nominal value if it is realised at maturity.

AC.16 Given the very strong likelihood that Transfercom will not need to realise the bond before maturity, the relatively short period until redemption and the current estimated transfer price of the bond (which is in excess of the amount for which I have assumed it can be realised, if required, in my modelling) I have not allowed for liquidity risk within my updated capital model.

Revised approach to presenting results of modelling

AC.17 As set out in Section 4.58 of my Independent Expert Report and Section 3.36 of my Supplemental Report, there is a risk to the transferring business that the claims on the existing business exhaust the applicable (and extended) reinsurance cover for that business and the capital levels of Transfercom. In practice the extremely long future period over which the claims in respect of the existing business are expected to be paid, compared to the transferring business, means that any such exhaustion would likely occur after all or most of the transferring claims have been paid. Nevertheless, to be conservative, I did not include any allowance for the different expected future payment periods of the existing and transferring business when assessing the security level for the transferring policyholders and accordingly, for my Previous Reports, assessed the likelihood of Transfercom being able to pay all future claims for both the existing and transferring policyholders as 97.5%. In light of the considerations in Section 3.62 above I regarded this as a satisfactory level of security.

AC.18 However a number of the objections raised have queried this security level and particularly compared it to a one-year value-at-risk view. In response to these queries my new modelling approach makes an explicit allowance for the different expected future payment periods of the two sets of policyholders and the resulting security levels. I have also compared in detail the resulting levels of security to the FSA's ICA criteria.

Revised assessment of reserves on the transferring book of business

AC.19 As set out in Sections 3.15 to 3.21 of this report, I have carried out a detailed investigation into the development of the reserves in respect of the transferring business in the 12 months from 31 March 2009 to 31 March 2010, together with all claims movements in April 2010. This investigation has been based on analysis of detailed schedules of movements in paid claims, case reserves and IBNR reserves. These schedules were supplemented by further cedant-specific narratives from Resolute to assist me to understand these movements and to understand their implications both for current reserves and reserve uncertainty.

AC.20 The table below summarises the booked reserves as at 31 March 2009 (as shown in my Independent Expert Report, although excluding the expected recoveries from Taisei Re on fronted contracts as this amount has now been received), 31 March 2010 and 21 April 2010.

**Booked reserves for transferring business
as at 31 March 2009, 31 March 2010 and 21 April 2010**

<i>All figures in US\$ millions</i>	As at 31 Mar 2009	As at 31 Mar 2010	As at 21 Apr 2010
Case reserves for losses and LAE	239.3	186.4	164.5
IBNR & related amounts			
Reserve for IBNR losses and LAE	22.5	20.0	19.5
Additional premiums relating to case reserves and IBNR	- 57.1	- 40.4	- 39.1
Profit commissions	9.9	7.8	7.8
	- 24.7	- 12.5	- 11.8
TOTAL CASE RESERVES PLUS IBNR & RELATED AMOUNTS	214.6	173.9	152.7
Unpaid paid loss amounts			
Unpaid paid losses	39.7	27.5	27.5
Additional premiums relating to unpaid paid losses	- 14.0	- 10.7	- 10.7
Unpaid paid profit commissions	0.3	0.0	0.0
	26.1	16.8	16.8
TOTAL CASE RESERVES, IBNR & RELATED AMOUNTS AND UNPAID PAID LOSS AMOUNTS	240.7	190.6	169.4
Claims paid since 31 March 2009 (net of additional premiums)			62.5

AC.21 The above table shows that the total case reserves, IBNR & related amounts and unpaid paid loss amounts have fallen by US\$71.3 million from 1 April 2009 to 21 April 2010. This compares with claims paid during the same period of US\$62.5 million, showing that the overall position of the transferring business has improved over the period. These figures are net of additional premiums.

AC.22 The results of my more detailed investigation described in Section 3.15 are that the most significant developments in either individual or groups of claims or legal disputes and arbitrations directly involving Sompo have led to an improvement in the current claims position of Sompo compared to the position in the PwC report at 31 March 2009. However this improvement has not always been reflected in the booked position as the ultimate claims position has historically only been altered in response to a PwC reserve review. As Sompo agreed to transfer the business to Transfercom during 2009, it did not commission a further annual IBNR review from PwC. As a result the ultimate claims position has been rolled forward so that it is largely fixed at the 31 March 2009 position.

AC.23 The results of my investigation are therefore that, while there have been some developments in either individual or groups of claims which have led to deteriorations in estimated ultimate claims, overall the developments represent a material improvement in total case reserves and IBNR beyond the booked position as at 21 April 2010, as set out above, of US\$17.2 million.

- AC.24 In addition, the developments in the estimated ultimate claims which have occurred since 31 March 2009 have impacted the uncertainty of the reserving position and overall have reduced the uncertainty around the ultimate claims position of the transferring book.
- AC.25 I have reflected these developments in the reserving position, and the certainty around this position, in my updated capital model. The overall effect of these changes is to significantly reduce the risk that the claims from the transferring business will exceed the level of the applicable NICO reinsurance cover.
- AC.26 In forming my opinion on the distribution for potential outcomes for the transferring book, I have placed reliance on the analysis and commentary described in my Independent Expert Report together with my recent detailed investigation into the development of the reserves in the 12 months from 31 March 2009 to 31 March 2010, together with all claims movements in April 2010. The individual claims and legal issues are confidential, but in summary my views on the reserve uncertainty, which I have incorporated into my more detailed capital model, are as follows:
- The case reserving and PwC IBNR reserving approach is conservative and in many cases takes a worst case or at least pessimistic view of the possible outcomes on individual claims or legal issues. As described in Sections 3.15 to 3.21 above, the outcome of my detailed investigation into the development of the reserves in the 12 months from 31 March 2009 to 31 March 2010, together with all claims movements in April 2010, was that the developments represent a material improvement in total case reserves and IBNR beyond the booked position as at 21 April 2010 of US\$17.2 million. I have assumed that the updated level of total case reserves and IBNR, after allowing for this improvement, represents the 75th percentile of the distribution of possible outcomes.
 - Based on my detailed investigation, there are also a number of areas where I have amended the possibility for deterioration beyond the updated level of total reserves. In each of these individual cases the view of Resolute's claims department is that such deterioration is unlikely and would for example involve reserve levels on market losses deteriorating significantly beyond current market expectations. Nevertheless I asked Resolute to provide further information to enable me to quantify the effects of these possible deteriorations.
 - Examples of such deteriorations include:
 - That Sompo loses its remaining dispute and that the opponent's legal fees are payable in addition to the full amount claimed by the other party;
 - A market loss deterioration in the aviation claims in respect of the World Trade Center loss – given the level at which Sompo's reinsurance attaches this has de minimis impact on Sompo;
 - That all aviation cedants present World Trade Center losses on a two loss basis even though this may reduce their overall reinsurance recoveries but (due to the levels at which Sompo's reinsurance attaches) increase recoveries from Sompo;
 - That the World Trade Center property subrogation claims are collected on a two loss basis across the market.

- Aggregating the worst case on all the areas I identified would give an aggregate deterioration to total case reserves and IBNR as at 21 April 2010 (after allowing for the improvement of US\$17.2 million noted above) of US\$16.7 million. I have assumed that this level of deterioration on all such claims at the same time represents a 97.5th percentile of the distribution of possible outcomes. This is a reduction in the aggregate deterioration (from the 75th percentile to 97.5th percentile), compared with the US\$20.5 million assumed in the modelling undertaken to support my Independent Expert Report. The reduction in aggregate deterioration has arisen due to the settlement of both claims and legal issues during the period since my Independent Expert Report was finalised as commented in Section AC.24 above.
- Given the occurrence liability nature of the book there is a possibility of some form of latent claims development. As discussed in my Independent Expert Report, I would place this probability in the extreme tail of the distribution as the nature of a predominantly aviation reinsurance book is that large claims normally originate from a headline event. I have also discussed the issue of latent claims further in this report in Sections 3.53 to 3.56.

AC.27 I have assumed that much of the remaining uncertainty should be resolved in a short period and so have assumed that the reserve uncertainty described above will, if it emerges, develop over a 1 year period.

AC.28 As stated in Section 4.37 of my Independent Expert Report, I have not considered ULAE amounts in my modelling, as in my opinion it is very unlikely that the reinsurance limit for ULAE of US\$25 million will be breached and even if it is the effect would be immaterial compared to the potential for breach of the indemnity limit of the reinsurance. This opinion was based around the current levels of annual expenses (which would be expected to decrease over time) and the likely term to settlement of the reserves.

AC.29 I have based the expected payment pattern of the claims on information provided by Resolute on the likely payment profile of the book. In order to assess the likely payment profile, Resolute undertook the following work:

- The major cedants and the levels of payouts experienced over the last few years were reviewed in detail.
- Consideration was given to specific arbitrations and commutations, including a specific review of the World Trade Center property subrogation settlement by cedant and a review of the plaintiffs that did not take part in the current World Trade Center property settlement.

AC.30 Resolute provided two alternative payment profiles based on different alternative assumptions with respect to a specific cedant. The first payment pattern assumed that the claim for this cedant would be settled during the current financial year and the second payment pattern assumed that the claim would go to arbitration, with the accompanying delays. The actual assumed payment amount was unchanged between the two patterns. However, the results of my modelling were not impacted by which of the two payment profiles was selected.

AC.31 This information seemed reasonable to me given my knowledge of the book of business. The assumed payment profile (as a percentage of total reserves) is as follows:

Year ending	Percentage of outstanding claims as at 31 March 2010 to be paid during year
31 March 2011	52%
31 March 2012	19%
31 March 2013	14%
31 March 2014	11%
31 March 2015	4%
31 March 2016	1%

AC.32 The resulting mean outstanding term of liabilities is two years (which assumes that all claims are paid at the end of the above annual periods).

Revised assessment of reserves on the current book

AC.33 For the reserve uncertainty of the current business within Transfercom I have used the reserve distribution as discussed in Sections 3.15 to 3.27 of my Supplemental Report.

AC.34 In addition, as stated in Section 4.52 of my Independent Expert Report, I have not considered ULAE amounts in my modelling, as in my opinion it is very unlikely that the reinsurance limit for ULAE of US\$50 million will be breached and even if it is the effect would be immaterial compared to the potential for breach of the indemnity limit of the reinsurance.

AC.35 The survival ratio method used in the White report for projecting asbestos reserves assumes an emergence of asbestos claims and so implicitly includes a payment profile. I have been provided with an overall payment profile for the full book of business by Resolute which effectively is based around adjusting the asbestos profile for the lower survival ratios on other books of business.

AC.36 The resulting mean outstanding term of liabilities is greater than 10 years.

AC.37 I have assumed that the reserve uncertainty on this book of business will emerge over a period equal to this mean outstanding term.

Correlations between the reserve uncertainty on the two books of business

AC.38 For the assumption as to the correlation between the two books of business I have assumed a correlation of 0.3 (30%), as for both of my Previous Reports and as described in Section 4.53 of my Independent Expert Report. This factor represents the likelihood of both books of business experiencing reserving deteriorations at the same time. The lower the factor the lower the chance of the books deteriorating at the same time and hence the lower the chance of Transfercom not being able to pay all its claims.

AC.39 As explained in Section 4.53 of my Independent Expert Report, the assumption was based around the factor used by CEIOPS in the QIS 4 standard formula for reserve risk correlation between marine aviation & transport and third party liability business. This factor was 0.25

(25%) and I increased it in light of the small amount of asbestos reserves in the transferring book and the small amount of World Trade Center reserves in the existing Transfercom book.

AC.40 Since my Previous Reports, CEIOPS have maintained the 0.25 (25%) factor for the proposed Solvency II standard formula in QIS5. I consider that my assumption of a 0.30 (30%) factor remains reasonable.

Security of policyholders transferring from Sompo to Transfercom – conclusion

AC.41 My assessment of the Post Scheme security of the transferring policyholders (and of the existing Transfercom policyholders) was based around the level of policyholder protection required for FSA authorised companies under the ICA regime. Under this regime, security has to be at least equal to a 99.5% confidence level over a one-year timeframe that the value of assets of the company will exceed the value of liabilities. This implies a 0.5% chance of failure in that the value of the liabilities do not meet the value of the assets after one year.

AC.42 FSA guidance is that companies can select a longer time horizon than one year for this assessment, in which case the percentage confidence level does not have to be as high, as it relates to a longer period. A longer time horizon is particularly common for non-life firms in run-off where the typical approach is to use a time horizon over the entire outstanding duration of the business; so an assessment is made of whether the company will meet all of its liabilities over the full period until its last liability has been met. I will sometimes refer to this as a confidence level “on a run-off to ultimate” basis in this report.

AC.43 Under this “run-off to ultimate” approach the standard rule of thumb when setting the required confidence level percentage is to reduce the 99.5% confidence level over a one-year timeframe by 0.5% for each year that the mean outstanding term of liabilities is greater than one, up to a maximum of five years.

AC.44 Hence, acceptable security levels are as shown in the table below.

<i>Mean outstanding term of liabilities</i>	<i>Confidence level</i>	<i>Chance of failure</i>
1	99.50%	0.50%
2	99.00%	1.00%
3	98.50%	1.50%
4	98.00%	2.00%
5 or greater	97.50%	2.50%

AC.45 Taking the example of a book of business with a mean outstanding term of three years, the acceptable chance of failure under the FSA’s ICA regime is 1.5% over the full three years which is equivalent to a 0.5% chance of failure over each of the individual three years.

AC.46 So the lowest level of confidence that is permitted as standard by the FSA for a non-life company in run-off is a 97.5% level of confidence that the company has sufficient assets to

meet all of its liabilities over the full period until its last liability has been met. This level of confidence applies when the mean term of liabilities is greater than five years.

- AC.47 As a matter of established policy and to facilitate Part VII transfers, the FSA does not insist on equivalent (or increased) security levels for each set of policyholders post-transfer (compared to the pre-transfer position). In my opinion, in the absence of other reasons for objecting, the FSA is unlikely to object to a scheme if it concludes that the scheme has no material adverse effect on policyholders' security.
- AC.48 In my Previous Reports I confirmed that the likelihood of Transfercom being able to pay all future claims once the Proposed Scheme has been effected was 97.5%. I confirm that my conclusion on this point is unchanged. Given the mean payment term of Transfercom's liabilities after the Proposed Scheme (which is greater than 5 years) this level of security is satisfactory in my view. (In my view this is equivalent to a 99.5% confidence level over a one-year time horizon.)
- AC.49 As regards the position of transferring policyholders, however, as explained in Section AC.17 of Appendix C, this is a conservative assessment as it does not take into account the relative advantage that transferring policyholders have when compared to the existing Transfercom policyholders as a result of the different mean terms of Transfercom's liabilities to these two groups of policyholders: put simply, on average Transfercom will pay claims to transferring policyholders many years before it pays claims to its existing policyholders, which means the risk of a Transfercom insolvency is less for transferring policyholders than it is for existing Transfercom policyholders.
- AC.50 As some objectors have expressed concern about the difference between security in excess of 99.5% over one year to security of at least 97.5% on a run-off to ultimate basis, I set out below the Post Scheme position of transferring policyholders and existing Transfercom policyholders on a run-off to ultimate basis, using the results of some further modelling which takes into account the different mean terms of Transfercom's liabilities to the two groups of policyholders.
- AC.51 The transferring policyholders are moving from a large, well diversified and strongly capitalised company, with a AA- security rating from Standard & Poor's. The FSA's ICA solvency criterion of 99.5% over a one year time horizon is normally taken as approximating to a BBB rating. In fact, the Standard & Poor's report "Default, Transition, and Recovery: 2009 Annual Global Corporate Default Study And Rating Transitions" (the "S&P 2009 Default Study") shows the one year Global Corporate Average Default Rate for entities rated BBB as 0.24% (implying a 99.76% security level, rather than the 99.5% of the FSA). The equivalent Standard & Poor's figure for a company rated AA- is 0.04% implying a confidence level over a one year time horizon of 99.96%. Over a two year period the figure is 0.12% implying a security level of 99.88%; so allowing for the fact that the mean term of the liabilities of the transferring business is around two years, its security level within Sompo would be 99.88%.
- AC.52 Considering the security of the transferring business over its mean term of two years, and combining my selected distributions for the transferring business and the existing business within Transfercom (as set out in Sections AC.19 to AC.37 in Appendix C), together with my chosen correlation, investment income and credit risk assumptions (as set out in Appendix C), my updated model estimates that the likelihood of Transfercom being able to pay all future claims on the transferring business after the Proposed Scheme has been effected is 99.6%.

AC.53 Based on my analysis, I therefore consider that the level of security for the transferring policyholders will reduce from 99.88% to 99.6% on a run-off to ultimate basis if the Proposed Scheme is approved. However, I believe that the level of security of the transferring policyholders would remain satisfactory in that the probability of Transfercom being able to pay all future claims to the transferring policyholders after the Proposed Scheme would be 99.6% on a run-off to ultimate basis. As the mean term of the liabilities of the transferring business is around two years the considerations set out in Sections AC.41 to AC.46 above would imply that the required run-off to ultimate security level under the FSA's ICA regime for this book of business would be 99%.

Security of current policyholders of Transfercom – conclusion

AC.54 If the Proposed Scheme does not go ahead, my modelling, with the additional changes set out in Section AC.9 above, estimates that the likelihood of the existing assets within Transfercom being sufficient to pay all claims from the existing business within Transfercom is 95.2%. This is an increase from the assessment in my Independent Expert Report, since the increase in security as a result of making an explicit allowance for future investment income slightly outweighs the reduction in security as a result of making an explicit allowance for credit risk.

AC.55 In conjunction with the Proposed Scheme the limit of the reinsurance with NICO which protects the current business of Transfercom will increase by US\$100 million. At the time of finalising my Independent Expert Report the limit of this reinsurance with NICO was due to be increased by US\$75 million and at the time of finalising my Supplemental Report the limit of this reinsurance was due to be increased by US\$80 million.

AC.56 The benefit of this increase in reinsurance is offset, but only to a limited extent, by the following:

- an increase in the counterparty credit risk in respect of the increase in the reinsurance arrangements with NICO;
- the possibility of the transferring business exceeding its applicable reinsurance protection, and accessing, or possibly exhausting, the free capital in Transfercom; and
- the potential erosion of Transfercom's capital due to the operation of the new Funds Withheld Endorsement under the reinsurance policy protecting the transferring business (see Section 3.88).

AC.57 The second offsetting factor has reduced significantly in impact since my Previous Reports given the significant improvements in the reserving position of the transferring business, as set out in Sections AC.19 to AC.26 of Appendix C.

AC.58 I have estimated that the likelihood of Transfercom being able to pay all future claims from the existing business of Transfercom after the Proposed Scheme has been effected is effectively unchanged from my previous assessment at 97.5%.

AC.59 Compared to my previous assessment the improvement in security from the allowance for future investment income, the increased net assets of Transfercom (from existing investment income) and from the improved reserving position of the transferring book is almost exactly

offset on a Post Scheme position by the counterparty risk of the reinsurance covers and of the bond held by Transfercom.

AC.60 The Post Scheme position represents a significant improvement in security for the current policyholders of Transfercom compared to the Pre Scheme position and therefore I believe that the current policyholders of Transfercom will be advantaged by the Proposed Scheme. In addition the resulting security level is, given the mean term of payment (of greater than 10 years) of the existing policyholders, satisfactory in my view. (In my view this is equivalent to a 99.5% confidence level over a one-year time horizon.)

Sensitivity analysis

AC.61 My conclusions above are based on the modelling I have undertaken, and the underlying assumptions I have selected. In order to understand the sensitivity of the modelling to my selected assumptions I have also undertaken my modelling using alternative assumptions. I have considered in particular those assumptions which are key or more uncertain. The results of this sensitivity analysis are set out below.

Expected payment pattern of transferring business

AC.62 I have considered the impact on my conclusions if the payment profile of the transferring business is altered, such that the mean payment term of the transferring business is increased from two years to five years.

AC.63 On this assumption:

- My modelling estimates that the likelihood of Transfercom being able to pay all future claims on the existing business after the Proposed Scheme has been effected is 97.2% on a run-off to ultimate basis.
- My modelling estimates that the likelihood of Transfercom being able to pay all future claims on the transferring business after the Proposed Scheme has been effected is 98.6% on a run-off to ultimate basis.

AC.64 Based on this analysis, I therefore consider that the level of security for the transferring policyholders will reduce if the Proposed Scheme is approved. However, I believe that the level of security of the transferring policyholders would still remain satisfactory in that the probability of Transfercom being able to pay all future claims to the transferring policyholders after the Proposed Scheme would be 98.6% on a run-off to ultimate basis. As the mean term of the liabilities of the transferring business on this basis is five years the considerations set out in Sections AC.39 to AC.44 above would imply that the required run-off to ultimate security level under the FSA's ICA regime for this book of business would be 97.5%.

Recovery rate on NICO reinsurance

AC.65 I have considered the impact on my conclusions if the recovery rate assumption is increased from 50% to 60% or reduced from 50% to 40%. The recovery rate assumption is the assumed average recovery on claims against NICO, if NICO defaults.

AC.66 Assuming a recovery rate of 60%:

- If the Proposed Scheme does not go ahead, my modelling estimates that the likelihood of the existing assets within Transfercom being sufficient to pay all claims from the existing business within Transfercom is 95.3%.
- My modelling estimates that the likelihood of Transfercom being able to pay all future claims from the existing business of Transfercom after the Proposed Scheme has been effected is 97.8%.
- My modelling estimates that the likelihood of Transfercom being able to pay all future claims on the transferring business after the Proposed Scheme has been effected is 99.7%.

AC.67 Assuming a recovery rate of 40%:

- If the Proposed Scheme does not go ahead, my modelling estimates that the likelihood of the existing assets within Transfercom being sufficient to pay all claims from the existing business within Transfercom is 95.0%.
- My modelling estimates that the likelihood of Transfercom being able to pay all future claims from the existing business of Transfercom after the Proposed Scheme has been effected is 97.4%.
- My modelling estimates that the likelihood of Transfercom being able to pay all future claims on the transferring business after the Proposed Scheme has been effected is 99.6% (i.e. unchanged at this level of rounding).

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Appendix D: Legal Opinions

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22 October 2010

Towers Watson
Watson House
London Road
Reigate
Surrey RH2 9PQ

Your reference

Our reference
EXXM

Direct line
020 7090 4313

For the attention of Graham Fulcher

Dear Sirs,

**In the Matter of Sampo Japan Insurance Inc ("Sampo")
Claim No: 6252010**

You have requested us to provide a legal opinion in relation to certain matters which have arisen in connection with proposed transfer of certain business from Sampo to Transfercom Limited ("Transfercom").

We set out below each of the matters which you have asked us to address, followed by our opinion in relation to that issue. Before doing so, we set out the basis of the opinion in this letter. In particular:

1. This letter sets out our opinion on certain matters of English law as at today's date. We have not made any investigation of, and do not express any opinion on, any other law.
2. For the purposes of this letter we have examined:
 - (a) a Portfolio Run-off Reinsurance Agreement between Transfercom and National Indemnity Company ("NICO") dated 1 December 2006 (the "2006 Reinsurance Contract");
 - (b) a Framework Agreement between Sampo, NICO and Transfercom dated 1 October 2009 (the "Framework Agreement");
 - (c) a letter from NICO to Transfercom dated 21 January 2010;
 - (d) a Portfolio Run-off Reinsurance Agreement between Transfercom and NICO dated 10 March 2010 (the "2010 Reinsurance Contract" and together with the 2006 Reinsurance Contract the "Reinsurance Contracts");

CFI Saul
SM Edge
NPG Boardman
GW James
EA Codrington
RMG Goulding
GES Seligman
PFJ Bennett
RM Fox
RJ Thornhill
GJ Ains
GP White
NJ Archer
AG Balfour
CM Horton
EA Barrett

PP Chappatte
RJN Cripps
P Jolliffe
CD Randell
WSM Robinson
RV Carson
SL Edwards
JM Featherby
F Murphy
PM Olney
PH Stacey
CWY Underhill
OA Wareham
RJ Clark
SJ Cooke
DL Finkler

CW Harvey-Kelly
JD Rice
MA Whelton
MD Bennett
RD de Carle
SP Hall
WJ Sibree
RC Stern
JR Triggs
EGL Wylde
A Beare
JD Boyce
MEM Hattrell
KI Hodgson
N von Bismarck
PWH Brien

JM Fenn
AN Hyman
AC Johnson
EF Keeble
KR Davis
SR Galbraith
NDF Gray
MS Hutchinson
SRB Powell
AG Ryde
JAD Marks
SD Warnakula-suriya
DA Wittmann
TS Boxell
SJ Luder
AJ McClean

JC Twentyman
GN Eaborn
HK Griffiths
STM Lee
AC Cleaver
EJD Holden
KM Hughes
G Iversen
DR Johnson
RE Levitt
S Middlemiss
RA Swallow
DCR Waterfield
DJ Bicknell
CS Cameron
CA Connolly

PJ Cronin
BJ-PF Louveaux
MS Rowe
MST Leung
R Doughty
E Michael
RR Ogle
SL Paterson
PC Snell
HL Davies
JC Putnis
RA Sumroy
GP Brown
JC Cotton
RJ Turnill
WNC Watson

MJ Dwyer
T Pharoah
SR Nicholls
MJ Tobin
DG Watkins
BKP Yu
EC Brown
RA Chaplin
J Edwarde
AD Jolly
S Maudgil
JS Nevin
JA Papanichola
JM Zaman
RA Byk
GA Miles

GE O'Keefe
MD Zerdin
SFL Cardell
RL Cousin
BJ Kingsley
IAM Taylor
DA Ives
MC Lane
LMC Chung
RJ Smith

Regulated by the Solicitors
Regulation Authority
Firm SRA number 55388

Document number
LT102950128

- (e) a proposed endorsement number 2 to the 2006 Reinsurance Contract ("Proposed 2006 Endorsement No. 2");
- (f) a proposed endorsement number 1 to the 2010 Reinsurance Contract ("Proposed 2010 Endorsement No. 1"); and
- (g) a draft witness statement of Andrew Wilson.

3. For the purposes of this letter, we have assumed each of the following:

- (a) Each party to each of the documents has the capacity, power and authority to:
 - (i) execute and deliver each of the documents; and
 - (ii) exercise its rights and performance obligations under each of the documents.
- (b) Each party to each of the documents has taken all necessary corporate action to authorise:
 - (i) the execution and delivery of each of the documents; and
 - (ii) the exercise of its rights and performance of its obligations under each of the documents.
- (c) Each of the documents has been duly executed by each of the parties to it.
- (d) All signatures are genuine.
- (e) The copy documents provided to us are complete and accurate as at today's date and conform to the originals.
- (f) The performance of each obligation under each of the documents:
 - (i) is not illegal in any place outside England and Wales in which that obligation is to be performed; and
 - (ii) is not contrary to any exchange control regulations of any member of the International Monetary Fund.

Opinion

4. Based on and subject to the foregoing, we are of the opinion that the Reinsurance Contracts are enforceable in accordance with their terms under English law.

5. Turning now to the specific areas you have asked us to address:

The circumstances in which Transfercom could lose the benefit of each of the Reinsurance Contracts (whether under the terms of each of the Reinsurance Contracts or under the common law), for example due to late notification, time bar, breach of policy terms, exclusions or cancellation.

There are a number of issues to address in relation to this. A key concern in such circumstances is usually that the reinsurer may be able to avoid the contract on the basis of a misrepresentation or non-disclosure. In our view this right is severely limited in relation to the Reinsurance Contracts. Clause 10 of each of the Reinsurance Contracts effectively excludes the right of the reinsurer to avoid that contract for non-disclosure or misrepresentation (whether innocent or negligent). We consider that this clause would not remove the right of the reinsurer to avoid on the grounds of deceit or fraud; we should, however, stress that we are not aware of any facts which would suggest that such a right would arise in this instance. Our view in relation to whether the 2010 Reinsurance Contract is avoidable is reinforced by clause 5 of the Framework Agreement and the letter dated 21 January 2010, both of which appear to confirm the intention of the parties that NICO shall not be entitled to avoid or cancel the 2010 Reinsurance Contract.

In relation to misrepresentation, our view is that the clause 10 in the Reinsurance Contracts does not clearly exclude or limit liability in damages which may arise (for example, in the case of a negligent misrepresentation); however, the clause does make clear that the reinsurer may not decline to indemnify the reinsured even in the case of a negligent misrepresentation. Although clauses 11 (Errors and Omissions) and 14 (Entire Agreement) touch upon a similar subject matter, they also do not expressly exclude liability for misrepresentation damages. We should add that there is some debate about whether damages are available for misrepresentation in the context of insurance and reinsurance contracts, but the English Courts (without formally determining the issue) appear to have worked on the basis that such damages are available. In this context, we have considered the terms of the Proposed 2006 Endorsement No. 2 and the Proposed 2010 Endorsement No. 1; we confirm that those endorsements (if validly entered into) should have the effect of excluding liability for misrepresentation (other than fraudulent misrepresentation).

It is also important in this context to consider the nature of the reinsurance provisions in the Reinsurance Contracts. Importantly in this regard, clause 2.3 of the Reinsurance Contracts makes clear that the reinsurance is on the same terms and conditions as the original risks accepted by Transfercom. Accordingly, NICO will be liable for payments made by Transfercom to its reinsureds under the underlying policies. Transfercom's position is further assisted by the wide ambit of the "Follow the Settlements" provision at clause 2.4 of the Reinsurance Contracts; we consider the effect of this is that settlements made by Transfercom with its reinsureds will be covered by the reinsurance where Transfercom has entered into them in a honest and businesslike manner and determined that the claim falls within the inwards policy.

It is also important to note that, other than the payment of the premium (which in respect of the 2010 Reinsurance Contract, will be deemed to take place in the event that the parties enter into

Proposed 2010 Endorsement No. 1), the Reinsurance Contracts do not appear to impose any further material obligations upon Transfercom or seek to impose any additional exclusions beyond those contained in the inwards policies. Similarly, the Reinsurance Contracts do not impose notification requirements beyond the provision of debit notes on a quarterly basis, and do not seek to make the timely provision of such information a condition or condition precedent to liability; accordingly we do not consider it likely that Transfercom could lose the benefit of cover on this ground. Further, although it is of course theoretically possible that a claim by Transfercom could become time-barred, the Reinsurance Contracts do not seek to impose any shorter period than that provided under general law, and so this is unlikely to be an issue in practice.

Whether the Reinsurance Contracts would survive the sale or disposition of Transfercom by NICO/Berkshire Hathaway and if so by what mechanism is this achieved?

Nothing in the Reinsurance Contracts provides that they may be terminated or will otherwise come to an end as a result of a transfer of the ownership of Transfercom. Accordingly, as Transfercom will continue in existence as a legal entity following any such transfer, the Reinsurance Contracts will survive and be enforceable by Transfercom in the same manner as before the transfer. No additional mechanism is required to achieve this.

What rights, if any, exist to permit transferring policyholders to claim directly against NICO in place of Transfercom?

We do not consider that any such rights exist.

What rights, if any, of claims control NICO has over claims made against Transfercom by transferring policy holders, which could in turn become claims made by Transfercom against NICO under the 2010 Reinsurance Contract?

We do not consider that NICO has any such rights.

The extent to which the Reinsurance Contracts may cover any fees and expenses incurred by Resolute in the management of the run-off of the transferring book of business on behalf of Transfercom?

In each of the Reinsurance Contracts there is a provision requiring NICO to indemnify Transfercom in respect of what are termed "*Internal Expenses and Fees*"; this indemnity applies whilst the relevant policy has not been fully exhausted by reinsurance claims and there is a separate limit in each Reinsurance Contract in relation to Internal Expenses and Fees. We consider that the definition of Internal Expenses and Fees is sufficiently broad to cover the fees and expenses incurred by Resolute in the management of the run-off of the transferring business. As indicated, it is important to note that in each of the Reinsurance Contracts the limit available to cover Internal Expenses and Fees is in addition to the reinsurance cover provided and so the available cover should not be eroded by payment of such expenses and fees.

How the Reinsurance Contracts and the Framework Agreement would operate if the Part VII Transfer is not recognised for certain policy holders for whatever reason in non-UK jurisdictions?

As a matter of English law, the transfer of all policies included within the Part VII transfer will be effective as a result of the Court's sanctioning of the scheme; it may be, however, that the English Court's Order in this regard will not be recognised in every jurisdiction. The question, therefore, arises with regard to how the 2010 Reinsurance Contracts and the Framework Agreement will operate in such circumstances. Our view is as follows:

- (a) The 2010 Reinsurance Contract provides reinsurance in respect of the "Protected Portfolio". This is defined to mean the reinsurance of inwards business accepted by Transfercom through the Part VII transfer. Therefore, if a claim is made successfully against Transfercom (in whatever competent jurisdiction) on any such policy, Transfercom should in turn be able to claim the loss under the 2010 Reinsurance Contract;
- (b) However, if the Part VII is not recognised and a claim on any such policy is successfully brought against Sompo after the Effective Date of the Scheme, then NICO will be liable to indemnify Sompo in relation to those losses under the Framework Agreement. In particular, clause 10 of the Framework Agreement provides that after the effective date of the Part VII transfer NICO shall indemnify Sompo against, inter alia, all actions, claims, losses, damages, payments or expenses in respect of the reinsurance contracts which were intended to be included in the Part VII transfer.

We should also mention that clause 10 of the Framework Agreement does not specify a limit to the indemnity provided under that clause. It does, however, provide that NICO shall have conduct of any proceedings in respect of any matter which gives rise to a claim under clause 10. Further, our view is that payments made under the indemnity in clause 10 of the Framework Agreement will in no way reduce the limit under the 2010 Reinsurance Agreement available to meet claims paid by Transfercom in respect of policies which have transferred pursuant to the Part VII transfer.

Sanctions

We understand that it has been suggested by a policyholder that it may be disadvantaged as a result of the transfer from Sompo to Transfercom because Transfercom is a company whose group is headed by a US company whereas Sompo is not; the particular concern arises out of the impact of sanctions imposed by the United States Treasury Office of Foreign Assets Control. Our view is that policyholders will not be disadvantaged. In particular, the Extraterritorial US Legislation (Sanctions against Cuba, Iran and Libya) (Protection of Trading Interests) Order 1996 applies to Transfercom (as a company incorporated in the United Kingdom) and provides in Paragraph 2 that a person:

“who commits a breach of Article 2 or the first paragraph of Article 5 of [Council Regulation (EC) No 2271/96 of 22nd November 1996] ... shall be guilty of an offence ... ”

The first paragraph of Article 5 of the relevant EU Regulation in turn provides:

“No person ... shall comply whether directly or through a subsidiary or other intermediary person, actively or by deliberate omission, with any requirement or prohibition, including requests of foreign courts, based on or resulting, directly or indirectly, from the laws specified in the Annex or from actions based thereon or resulting therefrom.”

The combined effect of these provisions is to make it a offence under English law for Transfercom to comply with the sanctions listed in the Annex to the EU Regulation. It is our understanding that these include the US sanctions which could apply to Transfercom (although this is a matter which you may wish to have confirmed by US lawyers). Accordingly, there is no basis for Transfercom to refuse to pay a claim from a cedant on the basis of the US sanctions and it will be committing an offence in England if it does so.

Set-off

We also understand that it has been suggested that a policyholder may be disadvantaged as a result of a transfer from Sompo to Transfercom if that same policyholder also reinsures Sompo. The reason for the suggested potential disadvantage is that currently the policyholder will under its reinsurance have claims against Sompo (the “Outward Claims”) but also, in its capacity as reinsurer of Sompo, will receive claims from Sompo (the “Inward Claims”); it is said that currently the policyholder has a right to set-off the Inward Claims against the Outward Claims and that this right would be lost in the event of a transfer of the reinsurance contracts to Transfercom as the Outward Claims would then lie against Transfercom rather than Sompo. In relation to this:

- (a) It is not clear whether it is being suggested that, leaving aside circumstances involving insolvency, a reinsured has a right to set-off Inward Claims against Outward Claims on separate policies of reinsurance. In any case, our view is that absent some agreement to this effect, such a right of set-off is unlikely to arise and so the transfer from Sompo to Transfercom cannot affect the set-off position in these circumstances. It is, of course, also the case that in a solvent context a policyholder’s net position should be the same regardless of a right of set-off. For example, even assuming that a policyholder has a right of set-off against Sompo prior to any transfer and that this would be lost as a result of the transfer, provided that Transfercom is solvent then the policyholder’s overall position will be no different as a result of the transfer as it will pay Inward Claims and receive the Outward Claims.
- (b) A right of set-off does arise in the event of an insolvency. So, for example, if (absent the transfer) Sompo were to become insolvent, we consider that a policyholder would be entitled to set-off the Outward Claims against the Inward

Claims. As the transfer will only transfer the Outward Claims, in the event of Transfercom becoming insolvent there would be no set-off of the Inward Claims and the Outward Claims.

Proposed 2010 Endorsement No. 1

We have considered the terms of the Proposed 2010 Endorsement No. 1 and comment as follows:

- (a) Nothing in that endorsement would, if it becomes effective, change any of the points set out above with regard to the operation of the 2010 Reinsurance Contract.
- (b) In the event that that NICO requires Transfercom to hold the relevant funds in a "Relevant Trust Fund" as set out in clause 5A.6 of the Proposed 2010 Endorsement No. 1, the endorsement provides that the trust will be set up "on terms acceptable" to Transfercom, provided that Transfercom is acting reasonably. Our view is that if NICO and Transfercom cannot agree terms, and Transfercom acts reasonably in considering terms which would be acceptable, then Transfercom would not be obliged to set up the trust.

We should also mention that the terms of the Proposed 2010 Endorsement No. 1 do not expressly provide that the FSA (or any future regulator) will have input into the terms of the trust. However, our view is that it would plainly be reasonable for Transfercom to reject terms which are unacceptable to its regulator and, accordingly, if Transfercom's regulator has requirements with regard to the terms of the trust then Transfercom can require those terms to be included in the event that the trust is agreed to be set up.

- (c) You have also asked us to consider the effect upon the 2010 Reinsurance Contract (if any) of a reduction in value of the assets (for example, as a result of poor investment selection) representing the Funds Withheld under the terms of the Proposed 2010 Endorsement No. 1 (whether or not the funds are held in a trust). In this regard:
 - (i) Although not expressly addressed in the endorsement, our view is that there is no obligation upon NICO to pay any further amounts (either into the funds withheld or the trust) in the event that the value of the assets so held goes down.
 - (ii) A reduction of value of the funds held (whether or not the funds are held in trust) would not have any impact on the obligations of NICO to pay claims and associated expenses. NICO's obligations are not in any way linked or limited to the investment performance of the funds held.

- (iii) We should mention that clause 5A.5 of the endorsement provides that Transfercom must pay to NICO interest (at a rate calculated in accordance with that clause) on the average balance of the funds. It is, therefore, possible that Transfercom will have to pay interest to NICO which exceeds the amount of any return on the investments and, indeed, Mr Wilson indicates in his statement that this is likely to be the case; Transfercom's obligation to pay interest is not limited either to the amount of the return it in fact obtains or to the value of any remaining investments representing the funds withheld.
- (iv) Finally, we should mention that if NICO requires Transfercom to pay the Funds Withheld into a trust, the amount which Transfercom must pay is not reduced as a result of any reduction in the value of the underlying investments. Similarly, in determining whether any amounts must be repaid by Transfercom to NICO under clause 5A.8 (balance of funds in excess of 102% of Outstanding Liabilities) or under clause 5A.9 (repayment to NICO following exhaustion of reinsurance contract) it is not clear that any reduction is to be made to reflect investment losses. Consequently, if Transfercom must pay sums under these provisions, they could in theory exceed the value of the underlying investments at that time.

In assessing the risk of these points (and particularly those at (c)(iii) and (iv) above), you should note that (although the endorsement does not address this issue), the draft statement of Andrew Wilson states that Transfercom will invest the Funds withheld in investments *"with high liquidity, of short duration and/or easily realisable and with high security (by which I refer to investments having at least a AA- rating)"*; he indicates that it is very likely that *"Transfercom would purchase short duration (ie, 6 months or less) US Treasury Notes with such funds"*.

In addition, if Transfercom is required pursuant to clause 5A.6 to place the Funds Withheld in a Relevant Trust Fund, the endorsement does not address whether Transfercom must transfer cash into the trust or whether securities of the type described by Andrew Wilson in his draft statement could also be transferred. The terms of the Relevant Trust Fund have to be acceptable to Transfercom (acting reasonably) and there would seem to be reasonable grounds for Transfercom to require the terms of the trust to permit the transfer of such securities, as well as cash (provided of course that assets with the relevant value are transferred into the trust). The endorsement does not specify a period of time within which payment into the Relevant Trust Fund must be made and, therefore, Transfercom would have a reasonable time in which to do so.

- (d) In the event that NICO becomes insolvent we consider that Transfercom's position is likely to be better if the Proposed 2010 Endorsement No. 1 is entered into than if it is not. This is because, absent the Proposed 2010 Endorsement No. 1, Transfercom will have paid all the funds to NICO and will then rank simply as an unsecured creditor of NICO in respect of NICO's obligations under the Reinsurance Contract. In contrast, the primary position under Proposed 2010 Endorsement No. 1 is that Transfercom will retain ownership of the funds which it can then apply to meet its obligations under its contracts with policyholders (and such application will simultaneously meet NICO's obligations under the 2010 Reinsurance Contract). In the case where a trust fund is established, Transfercom would remain the primary beneficiary and those funds should be applied to pay the amounts due from time to time from NICO under the 2010 Reinsurance Contract and so, for so long as the funds on trust have not been exhausted, Transfercom will be in a better position than it would be as an unsecured creditor of NICO. We should mention that there may be circumstances in which the terms of Proposed 2010 Endorsement No. 1 may be challenged by a liquidator of NICO but under English law this would be unlikely to leave Transfercom in a worse position than if it had not entered into Proposed 2010 Endorsement No. 1.
- (e) Save to the extent identified above, we do not consider that circumstances will arise which will lead to Proposed 2010 Endorsement No. 1 being detrimental to transferring policyholders compared with the situation where Proposed 2010 Endorsement No. 1 does not come into effect.

Proposed 2006 Endorsement No. 2

We have considered the terms of the Proposed Endorsement No. 2 and comment as follows:

- (a) Nothing in that endorsement would, if it becomes effective, change any of the points set out above with regard to the operation of the 2006 Reinsurance Contract.
- (b) You have also asked us to consider the position where any funds held in trust in accordance with the Proposed 2006 Endorsement No. 2 reduce in value. Our view is that the obligations of NICO under the 2006 Reinsurance Contract to pay claims and expenses are not linked to the performance of the fund and any investment losses would not reduce NICO's obligations. There is an issue that, as the funds will be transferred to Transfercom in the form of securities and it is intended that those securities could be liquidated in order to pay claims, problems may arise in the event that the securities are illiquid. Further, the endorsement requires Transfercom (or a third party trustee) to re-pay certain amounts to NICO if the balance of funds at an accounting date is greater than "Remaining Reserves" (as defined); issues may therefore arise in the event that the securities

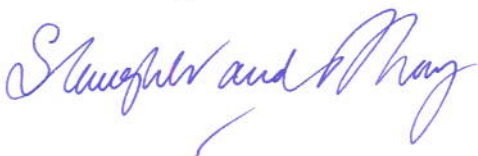
held significantly reduce in value between the accounting date and the date on which repayment must be made. Similarly, if NICO's rating recovers, Transfercom may be required (under clause 18.5) to re-pay the balance of the retained funds; given that there is no provision for reducing those funds to reflect a reduction in value of the underlying securities, it is possible that Transfercom will in those circumstances have to pay back an amount greater than the then current value of the underlying securities. Against this, however, as the funds (whether held by Transfercom or by a third party trustee) will be held in trust, it is clearly arguable that the liability to pay back should be construed as being limited to the extent of the funds remaining in the trust at that time.

We should mention that the endorsement does not specify that the securities transferred by NICO to Transfercom must be of the type in which it is proposed the funds under the Proposed 2010 Endorsement No. 1 will be invested; and Mr Wilson's draft statement does not make clear whether Transfercom anticipates that the transferred securities will be of this nature or whether it is Transfercom's intention to sell any securities not of that nature and replace the with such securities. In any case, it may be relevant to consider the proposed nature of the securities in assessing the risk of these issues,

- (c) In the event that NICO becomes insolvent, Transfercom would – without the Proposed 2006 Endorsement No. 2 – rank simply as an unsecured creditor NICO. However, the securities transferred to Transfercom pursuant to the terms of the Proposed 2006 Endorsement No. 2 should be available to meet NICO's obligations to Transfercom (to the extent of those assets). Similarly, the endorsement states that funds on trust will be held primarily for Transfercom and so they should be available to Transfercom in the event that NICO becomes insolvent. As above, we should mention that there may be circumstances in which the terms of Proposed 2006 Endorsement No. 2 may be challenged by a liquidator of NICO but under English law this would be unlikely to leave Transfercom in a worse position than if it had not entered into Proposed 2006 Endorsement No. 2.
- (d) Save to the extent identified above, we do not consider that circumstances will arise which will lead to Proposed 2006 Endorsement No. 2 being detrimental to transferring policyholders compared with the situation where Proposed 2006 Endorsement No. 2 does not come into effect. In this regard, we should also mention that this endorsement increases the limit under the 2006 Reinsurance Contract by US\$20,000,000 to US\$625,000,000 provided that the Part VII transfer from Sompo to Transfercom in fact proceeds.

Please do not hesitate to let us know if there are any further issues you would like us to address.

Yours faithfully,



Memorandum

TO	Graham Fulcher Kate Angell	DATE	9 September 2010
COPY TO	Wendy Wysong	FILE REF	81-40481323
FROM	George Kleinfeld 	DIRECT DIAL	+1 202912 5126

Sompo – Transfercom Part VII Transfer: OFAC Issues

This memorandum responds to your 26 August 2010 request for advice (the "**Request**") in connection with your assessment of whether US economic sanctions considerations may affect the actuarial analysis of the Scheme, as defined in the Request. We rely for purposes of our advice on the description of the Scheme set forth in the Request, as supplemented by our 27 August 2010 conference call with Ms. Angell.

I. OFAC Sanctions Programs

The US Treasury Department's Office of Foreign Assets Control ("**OFAC**") administers US economic sanctions under the authority of various statutes and executive orders, including: (a) the Trading with the Enemy Act ("**TWEA**"), applicable to economic sanctions against Cuba; and (b) the International Emergency Economic Powers Act, under which OFAC has implemented sanctions against Burma (Myanmar), Iran, Sudan and a range of other countries, persons and entities. With respect to certain sanctioned countries, the OFAC sanctions apply only to dealings with certain designated government officials or other specific targets; whereas, in the case of Cuba, Iran, Sudan, and to a lesser extent Burma, the prohibitions apply comprehensively to dealings with or within that country or involving its government.

II. Jurisdictional Reach of OFAC Programs

Compliance obligations under the TWEA-based OFAC program against Cuba generally apply to: (a) US citizens and residents of the United States, wherever located; (b) persons within the United States; (c) entities organized under US law, including foreign branches; and (d) any corporation, partnership, or association, wherever organized or doing business, that is owned or controlled by citizens and residents of the United States or a US entity. In contrast, under all of its other sanctions programs, which are based on statutory authority other than TWEA, OFAC does not assert jurisdiction over entities domiciled outside the United States even if they are US-owned or controlled except to the extent of their activities or transactions in or through the United States or involving US persons or US-origin goods.

Under this jurisdictional paradigm, Sompo, a non-US owned non-US domiciled entity, would not have OFAC compliance obligations in regard to its dealings with Cuba except to the extent such dealings involved the United States or US counterparties. In contrast, Transfercom, a US-

owned non-US domiciled entity, would have OFAC compliance obligations in regard to all of its dealings with Cuba globally, regardless of whether those dealings involved any US elements.

Under all other OFAC sanctions programs, the compliance obligations of Sompo and Transfercom would be identical. Unless their dealings with Iran, Sudan, Burma or other sanctions targets involved US elements (US persons, the territory of the United States or US-origin goods), neither company would be obliged to forego business with such sanctions targets.

There is one exception to this general rule. The recently-amended Iran Sanctions Act ("ISA") authorizes the President to impose sanctions against non-US entities in relation to their entirely non-US business, to the extent such business involves certain proscribed activities in Iran. We attach an overview memo on the ISA (and a separate overview memo on OFAC sanctions programs) for your general information. We do not believe the ISA is relevant to your analysis, however, because it applies both to Sompo and Transfercom to the extent either might engage in ISA proscribed activities.

III. Implications for your Analysis

For the reasons set forth above, we propose that you amend the current draft language included in the Request in regard to the implications of OFAC regulations for your analysis of the Scheme, such that the sentence in question would no longer read:

(a) the only OFAC sanctions that purport to be applicable to a company in the position of Transfercom are those relating to Cuba;

but would instead read as follows:

(a) the only OFAC sanctions program that would apply differently to Transfercom than to Sompo would be OFAC's Cuba sanctions, which would apply even to entirely non-US dealings of Transfercom with Cuba on the basis of the US ownership of Transfercom;

We would be glad to provide additional analysis upon request.

G.K.

Appendix E: Additional Information Received

For the purposes of this report I have reviewed the following information (in addition to that information already reviewed for my Independent Expert's Report and Supplemental Report):

- The written statements of objection to the Proposed Scheme received from:
 - Reynolds Porter Chamberlain LLP on behalf of Riverstone Management Limited and Riverstone Insurance (UK) Limited;
 - Fox Hartley on behalf of Axa Corporate Solutions Assurance;
 - Maitland Hudson & Co LLP on behalf of La Réunion Aérienne; and
 - ACE Overseas General, which comprises the operations of ACE Underwriting Agencies Limited and ACE European Group Limited (among others).
- A copy of the Court Order made on 26 March 2010
- A copy of the reinsurance contract with NICO which will cover the transferring business when the Proposed Scheme becomes effective
- A copy of the endorsement to increase the limit of the reinsurance contract with NICO, which covers the existing business within Transfercom, when the Proposed Scheme becomes effective
- A copy of the BBB endorsement to the existing contract with NICO
- A copy of the side letter (to the Framework Agreement and the reinsurance contract with NICO which covers the existing business within Transfercom) dated 21 January 2010
- A copy of the Funds Withheld endorsement to the reinsurance contract with NICO covering the transferring business
- Audited Annual Report and Accounts of Transfercom as at 31 December 2009
- Unaudited management accounts of Transfercom as at 31 March 2010 and 30 June 2010
- The Annual Statements for NICO as at 31 December 2009

I have also been provided with further additional documents for example, various detailed schedules of movements in paid claims, case reserves and IBNR reserves for the transferring business as well as cedant-specific narratives around some of the claims developments on the transferring business.