

Supplementary
Long Term Business
Information (Unaudited)

SUPPLEMENTARY LONG TERM BUSINESS INFORMATION (UNAUDITED)

INTRODUCTION

The UK insurance industry has developed an alternative approach to the recognition of profit from long term insurance business. The alternative approach seeks to present a more realistic view of the results of long term business operations and is known as the Achieved Profits basis. The Group continues to support this initiative. The basis is related to the principles of the embedded value of shareholders' interest in long term business, which the Group includes in the consolidated balance sheet and which is summarised in note 45 to the Group accounts. This supplementary statement provides an analysis of the movement in this interest in respect of those parts of the Group that report an embedded value and the key underlying assumptions adopted in its calculation.

Certain overseas operations report their long term business results in accordance with local accounting principles. Due in part to the distinct features of the life insurance markets in these territories and the fact that the local accounting principles are believed to show a fair result, no adjustment is made to their results on incorporation into this statement.

Following the recent release of the amended Statement of Recommended Practice (SORP) issued by the Association of British Insurers for insurance accounting in the UK, the Group is reviewing its policy of recognising embedded value in the balance sheet. Any adjustment would be introduced in 2003.

The major development in the year is in respect of the Danish Life business. Following clarification by the Danish Financial Supervisory Authority over the basis of sharing profit between policyholders and shareholders, £50m of previously unallocated surplus return has been attributed to shareholders. This item is included in the movement for the year. Discussions continue with the Danish Regulator as to whether any further surplus is available for release.

RATIONALE

To understand the rationale for the alternative approach it is necessary to appreciate the objectives underlying the statutory basis of long term business profit recognition in the UK. For a company conducting long term insurance business in the UK a separate portfolio of assets ("the fund") has to be maintained to ensure that all liabilities of the company to its policyholders can

be met at all times. Such a company is legally required to undertake a valuation in accordance with statutory regulations. These are primarily concerned with ensuring the financial security of the fund rather than assessing its performance in the period. The statutory method of profit recognition is based upon the statutory solvency valuation of the assets and liabilities of the fund. Under this approach the profit for shareholders is represented by the cash transfer from the fund following the actuarial evaluation.

In contrast, the rationale of the Achieved Profits method is to reflect the performance of the business in the period. The approach seeks to evaluate the cashflows to the benefit of shareholders expected to arise on existing long term business contracts. The change in value of the anticipated cash flow is reported in the years in which it can be regarded as having been earned, having regard to the risks implicit in the business.

It should be emphasised that the Achieved Profits method neither replaces the statutory evaluation nor does it change the timing of the release of cash to shareholders from the fund. The total profit attributable to shareholders will over time be the same under both approaches. The differences lie in the timing of the recognition of profit in the accounts.

INTERRELATIONSHIP WITH PRESENT ACCOUNTS

The Group generally reports life profit based on the statutory solvency valuation principles as adjusted in a number of respects. This approach is known as the Modified Statutory Basis ("MSB"). The Group balance sheet also includes a "Value of Long Term business" which represents a valuation of the shareholders' interest in the life operations. This includes the evaluation of overall profit expected to arise on existing long term business contracts but excludes any estimate of the value to shareholders of new business yet to be written. The result set out in this supplementary statement represents the movement in this value in the year.

As the same methodologies and assumptions have been applied in both the value of long term business and this supplementary statement, the alternative approach has no impact on total shareholders' funds and accordingly a balance sheet is not included in this statement.

SHAREHOLDERS' INTEREST IN LONG TERM BUSINESS (UNAUDITED)	UK	Europe	Americas	Asia Pacific	2002	2001
	£m	£m	£m	£m	£m	£m
Balance at 1 January	1,670	405	174	254	2,503	2,797
Exchange	-	19	(31)	10	(2)	(40)
Movement for the year	(236)	45	12	(1)	(180)	(173)
Dividends	(94)	(13)	-	(2)	(109)	(142)
Capital injections/(released)	(86)	25	-	12	(49)	233
Acquisitions/Reclassifications	(149)	-	13	-	(136)	4
Disposals	-	(153)	-	-	(153)	(176)
Balance at 31 December	1,105	328	168	273	1,874	2,503

NOTES:

- The shareholders' interest in long term business comprises the value of long term business, as shown in the Group balance sheet, together with shareholders' funds attributable to long term business but held separately from designated long term business funds and shareholders' accrued interest, being the excess of accumulated profit recognised under the modified statutory basis over the statutory transfers from the long term fund. This is shown in note 45 to the Group accounts.
- The results in respect of certain territories are in accordance with local accounting principles and have not been restated on consolidation. In each case the local basis is considered to represent a reasonable approach for the determination of the result from life operations.
- The results of other overseas business show the movement in the shareholders' interest in long term business, calculated in accordance with the same principles as apply to the UK business.
- During 2002 the Group disposed of its life operations in Benelux, Germany and the Isle of Man. The UK reclassification arises from the transfer of the unit linked operation Royal & Sun Alliance Linked Insurances Limited to the ownership of the Phoenix Assurance plc non participating fund and in respect of the Americas comprises the life operations in Mexico and Peru.
- In providing an analysis of the movement in the value of long term business as shown in the Group balance sheet it is also necessary to identify the effect of retranslating opening balances held in foreign currency to the year end rates of exchange.
- The value will change by the amount of any capital invested or divested by the Group into or out of its long term operations.

ANALYSIS OF MOVEMENT FOR THE YEAR IN SHAREHOLDERS' INTEREST IN LONG TERM BUSINESS

We have analysed the movement for the year in the shareholders' interest into the following components:

Value added by new business

The value added during the year for new business written net of all expenses attributable to the acquisition of the business grossed up for taxation at the relevant rate.

Expected return

The risk free investment return on the restated opening balance. The opening shareholders' interest in long term business balance is adjusted to include the impact of economic assumption changes from the beginning of the year (see below).

Operating margin

The differences between the actual results for the period and the expected experience at the start of the year together with the risk return earned on the restated opening balance.

Operating assumption changes

The impact of changes in the operating assumptions, which include mortality, expenses, persistency and bonuses to policyholders.

Economic assumption changes

The impact of changes in the investment return assumptions and the change in the discount rate.

Investment variances

The difference between the returns achieved during the period and the returns assumed.

Attributed tax

Embedded value profit is calculated on an after-tax basis and grossed up at the full corporation tax rate for UK business and at appropriate rates of tax for other territories.

ANALYSIS OF MOVEMENT FOR THE YEAR	2002	2001
	(unaudited)	(unaudited)
	£m	£m
Value added by new business	(9)	33
Expected return	116	146
Operating margin	177	135
	284	314
Operating assumption changes	(58)	(77)
Economic assumption changes	(279)	(72)
Investment variances	(202)	(420)
Gross movement attributable to the year before tax	(255)	(255)
Attributed tax	75	82
Movement for the year	(180)	(173)

Included in the operating margin for the year is a risk margin unwind of **£83m** (2001 £109m).

Operating assumption changes impacting 2002 were an increase in the assumed level of future lapse rates following the closure of the UK Life fund to new business and impact of revised lapse, commission and mortality assumptions in Asia Pacific operations. The changes in economic assumptions and investment variances reflect the impact of lower investment returns.

Overseas operations account for 41% of the total shareholders' interest in long term business.

VALUE ADDED BY NEW BUSINESS

In respect of new business written in the period, the analysis initially seeks to determine the overall profit that will accrue to shareholders over the life of the contract. The value is then restated, taking into account the timing of the expected transfers of the profit to shareholders and the various risks and uncertainties that will affect its emergence, by discounting the future cash flows. The risks and uncertainties exist in both the assumptions concerning the insurance experience, such as mortality, morbidity and lapse rates, and the assumptions concerning the performance of the company and the economic environment such as expenses, inflation and investment returns. The risks are reflected in the choice of discount rate.

PRE TAX NEW BUSINESS PROFIT – ACTUARIAL FACTORS	2002	2001
	(unaudited)	(unaudited)
	£m	£m
UK	19	39
Europe	8	13
Americas	9	10
Asia Pacific	13	11
Total value added by new business before tax	49	73

PRE TAX NEW BUSINESS PROFIT – FULLY COSTED	2002	2001
	(unaudited)	(unaudited)
	£m	£m
UK	(20)	23
Europe	(2)	(3)
Americas	9	8
Asia Pacific	4	5
Total value added by new business before tax	(9)	33

The UK result is significantly impacted by expense overrun following the decision to close to new business midway through the year. The result for Europe includes the development costs incurred within the EuroLife and Poland operations.

PRINCIPAL ECONOMIC ASSUMPTIONS

As indicated above, the value of long term business is dependant on assumptions concerning a range of factors that will influence the future profit emergence. These assumptions represent estimates based on recent experience and general economic conditions.

The principal assumptions in respect of the UK operation are as follows:

	2002 (unaudited) %	2001 (unaudited) %
Investment return:		
Government fixed interest	4.50	5.04
Other fixed interest	5.25	5.79
UK equities	7.00	7.54
Overseas equities	7.00	7.54
Expense inflation	3.00	3.20
Discount rate (including risk margin of 5.0% (2001 4.0%))	8.20	7.50

Principal assumptions outside of the UK vary from territory to territory. Government fixed interest returns range from 3.0% to 6.7% and discount rates range from 7.6% to 12.0%.

NOTES ON ASSUMPTIONS

- The assumptions represent expectations of future experience and have regard to past, current and future experience and to relevant external data. Favourable changes in experience are not anticipated unless the improved experience is reasonably certain. The projections bases for discontinuances, renewal and other expenses, mortality and morbidity, investment return and taxation are based upon an underlying assumption that the businesses are continuing as going concerns.
- The assumptions for future investment return reflect the current investment portfolio. The projected returns are based upon current fixed interest returns. The projected future returns on equity investments include a margin over the corresponding risk free (gilt edged) rates assumed.
- The discount rates used in the calculations reflect the relevant risk free (gilt edged) rates in the individual territories and include margins for risk.
- For with profits business, the assumptions regarding bonuses are consistent with the assumed investment returns and the company's bonus philosophy. For UK with profits business the reversionary bonus rate assumptions are consistent with the assumed investment returns and current terminal bonus scales; terminal bonuses are projected to make payouts proportional to asset shares that distribute all the assets of the with profits business after allowing for all associated shareholder transfers. Where the shareholders' profits are determined as a proportion of the cost of policyholder bonuses, the proportion is assumed to continue at the same level as is currently used.
- No account is taken of the value of future premiums under recurring single premium business (such as Department of Social Security rebate premiums) or for the value of future non-contractual increments on existing business. The value of such business is recognised in the value of new business in the period in which the premium is received.

ALTERNATIVE ASSUMPTIONS

The discount rate appropriate to any investor will depend on the investor's own requirements, tax position, and perception of the risks associated with the realisation of the future profits. The effects of changing the discount rate for the UK operations are:

	1% lower discount rate £m	As published £m	1% higher discount rate £m
Embedded value at 31 December 2002	1,137	1,105	1,073

It should be noted that in calculating these values all other assumptions have been left unchanged.

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